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## A Comprehensive Review of Accounting through Case Studies

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# A Comprehensive Review of Accounting through Case Studies

By

Adam Weekley

A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of the requirements of the Sally McDonnell Barksdale Honors College.

Oxford

May 2020

Approved by



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Advisor: Professor Victoria Dickinson



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Reader: Dean Mark Wilder

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## Abstract

Adam Scott Weekley: A Comprehensive Review of Accounting through Case Studies

(Under the direction of Dr. Victoria Dickinson)

The following thesis includes my responses to a variety of case studies discussing the fundamental principles of accounting. These are in line with the Financial Accounting Standards Board's Generally Accepted Accounting Principles. This thesis displays the application of a variety of said accounting principles to specific companies and how these principles apply to the decisions firms make every year. Throughout the 2018-2019 school year, under the direction of Dr. Victoria Dickinson, these cases were thoroughly completed and reviewed in accordance with the requirements of the Sally McDonnell Barksdale Honors College.

## Case 1: Data Analytics Case

Tableau

By

Adam Weekley

In this case, the students were assigned to groups of four, and each group was assigned a business information software to research and discuss. My group was assigned to the data analytics tool known as “Tableau.” The discussion begins with the founding of this software company, what the founders intended for the tool to be used for, and what sets Tableau apart from other business information software. Following a brief history and background, the plethora of applications for this software was discussed. First, how Tableau could be potentially used to make general business decisions was discussed. After this, there was a more in-depth discussion of how one might use this software in specific scenarios, such as in auditing or tax planning. Finally, the product and its merits were pitched as if to a future employer at a public accounting firm.

This case study opened my eyes to the extensive range of business information software options on the market. In addition, I learned that there is a significant application of the ability to code in the accounting world. This seems like a useful skill that I will attempt to teach myself over the next year or so. In answering the following questions about Tableau, I had to consider how an employee would potentially solve problems using the software. In concocting scenarios for my hypothetical future self, I had to consider how a business would maximize profits in new ways and how exactly employees might be trying to skirt around the internal controls to pocket some extra cash. Reflecting on these topics placed me in scenarios which I had not considered as potential future professions. I learned that I may be more interested in becoming a tax accountant than I had previously thought. In addition, I now know that I’d like to

become more acquainted with business information methods (coding, for example) before I step out into the world of accounting.

- 1. Identify the history and purpose of this tool and describe, in general, how it is used to make business decisions. Be specific about what kind of technology platform it uses, etc. and other resources that need to be in place to fully utilize the functionality of the tool.**

Tableau, a business intelligence and data analytics tool founded at Stanford, makes data analysis and the presentation of said analysis relatively simple. The main purpose of using Tableau would be to assist in the analysis of large sets of data, ranging from large corporation's sales revenues to batting averages of minor league second basemen. There are plenty of different softwares one could use to do this, but Tableau excels in being user friendly and creating easy to understand graphics without sacrificing the quality of the data analysis. This powerful software allows managers to make more informed and effective business decisions based on the data trends. For example, Tableau can analyze regional data, providing a map of sales hotspots and places where sales may have struggled last quarter. Managers can use this information to help decide how to allocate certain resources for the next quarter to maximize sales revenue. Managers could also use the time series data analysis tools Tableau has to offer. After integrating with big data platforms, like Hadoop, Tableau can analyze sales data trends over time, providing easy to understand graphs and insight on seasonal sales data. Managers could then, for example, decide to increase production at certain times of

year to meet larger demand. Depending on the business, though, Tableau has nearly limitless applications to helping those in charge of making business decisions.

**2. How, specifically, would you use the tool in the following business settings? Create at least three specific scenarios for each category in which the tool would lead to more efficiency and/or better effectiveness. Be sure to describe what kinds of data your tool would use for each scenario.**

**a. Auditing**

**b. Tax Planning**

a) Tableau can also simplify data analysis tasks for auditors. Internal auditors for merchandising firms could use the data analysis tools offered by Tableau to help evaluate internal shrinkage and theft. The loss of goods could be analyzed, and managers could take a closer look at specific trends that Tableau pulls from the data. For example, if there is a spike in theft in November, then the managers could consider hiring additional security for this period of time. Maybe the internal auditors suspect that a manager at a certain branch of a merchandising company is artificially inflating the reported cost of supply orders and pocketing the difference. The auditors could use Tableau to compare this branch's purchasing data to other branches across the region. Tableau could then analyze the data and help determine whether or not the manager in question was paying an excessive amount for the same goods as other stores in the area. External auditors could also make use of the tools Tableau has to offer. In order to ensure proper revenue recognition, auditors could evaluate the dates revenues are recognized for various departments and plot these values over time. They could specifically analyze revenue



trends around the ends of quarters and years compared to prior data on the company in search of outliers. These outliers could take the form of abnormally large spikes of revenue just before the end of a quarter or year or other irregularities. The auditor could then further look into these outliers to ensure that there is an explanation for the change in revenue patterns.

b) Tableau can simplify tax planning through the use of its data analysis tools as well. The regional heat mapping could be used to determine states (or sales regions on an international scale) where branches pay particularly large quantities of taxes per dollar of revenue generated in the region. Then, upper management would know which regions to focus on to try and reduce the amount of taxes they have to pay. Maybe they could move some production to a region with lower tax rates or something along these lines. Furthering this point, the managers could determine in which states they pay the fewest taxes per dollar of revenue and focus on moving as much production or sales to that state as possible. On the contrary, state governments could use a similar method in planning their tax legislation. Analysts could use Tableau to determine what regions, industries, or specific products pay the least amount of tax per dollar of revenue and target them with their next legislation. Private tax advisors could also certainly make use of Tableau to help their clients pay the least legal amount of taxes. Assuming that the private tax consultant had or could get access to a large database of private citizens and their tax and financial information, they could run an analysis to determine which folks pay the least amount of taxes per dollar of net worth. They could then look at these citizens more closely to attempt to imitate their methods to pay the minimum amount of taxes. I suppose this could also be used to investigate tax evasion.

**3) Write a few paragraphs to your future public accounting partner explaining why your team should invest in the acquisition of and training in this tool. Explain how the tool will impact the staffing and scope of your future engagements.**

To: Partners of Deloitte

From: Adam Weekley

Date: 18 September 2018

Subject: Tableau BI Software

Tableau would be a great investment for probably just about any large business, but it would especially be a wise investment for a public accounting firm like ours. Every department of our firm will be able to use this software to make data analysis easier and more efficient, and the easy to use interface will make it relatively simple to train our staff to use it. The payoff from this investment will be seen internally in the form of increased insight for management's decision-making processes through the use of Tableau's data analysis system. In addition, our external auditors will be able to do their jobs more efficiently once they have received training and have the ability to maximize their time through the use of Tableau.

Our internal management, from human resources to the folks in charge of buying office supplies, would benefit from having access to and the ability to utilize the tools of Tableau. With all of the data available to our human resources department about past hiring habits, Tableau could help determine who and from where we should be recruiting the most. It could analyze trends in pay and pay raises, helping management determine the most efficient pay raise rate to keep employees motivated. It could also be a big help when internally auditing purchases (of office supplies, for example), offering insight into

which supplies we spend the most money on. We could then focus on reducing the usage of the most expensive supplies. Wherever money is being spent, Tableau could be used to analyze where the money is going and if there are any trends that could be exploited to make our company more cost efficient.

As far as helping our external auditors, the goal of investing in Tableau would be to make their lives easier and more efficient on the job. This software excels in making graphics easy to understand, so when making presentations to clients and for external entities they can make their points more effectively and concisely. The auditors will need a bit more training in using the data analysis and graphic presentation tools than internal management, but it will be well worth it. The payoff over time will be a deeper comprehension of what our auditors' findings implicate for our clients and, as a result, higher client satisfaction.

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed

Adam Weekley

## Case 2: Rocky Mountain Chocolate Factory

By

Adam Weekley

Case Summary	What I learned
<p>In this case, students were given several financial transactions and the financial statements for Rocky Mountain Chocolate Factory in 2010. The students had to create their own excel spreadsheet and then journalize these transactions, filling them into the proper accounts. They then had to ensure that the final balances on their spreadsheet matched up to the given final balances for the accounts. The students also had to create an income statement and a balance sheet for the period, ensuring that these statements also matched up to the given statements. The students then recorded whether the journal entries were financing, operating, or investing transactions.</p>	<p>Recording the data and crafting the financial statements for Rocky Mountain Chocolate Factory made me learn quite a bit about using Microsoft Excel efficiently for accounting purposes. I learned how to link certain cells in one sheet to cells in a different sheet so that when a change is made in the journal, it immediately affects the balance in the financial statements as well. I also learned how to use formulae in Excel to make summing columns and rows much simpler. In addition, I learned that the material we've been learning in my accounting courses seems more directly applicable to the real world than I previously realized.</p>
<p>a) Prior to examining the company's actual balance sheet, read the description of Rocky Mountain Chocolate Factory, above. What accounts do you expect to see on the balance sheet? Which accounts constitute the major assets? Which accounts constitute the major liabilities?</p> <p>I expect to see cash, accounts receivable, inventory, property and equipment, accounts payable, notes payable, salaries and wages payable, and unearned revenues on the balance sheet.</p> <p>I assume the major assets will be cash and inventory and the major liabilities will be accounts payable and notes payable.</p>	<p>e) list three adjustments or reclassifications that might be necessary based on the unadjusted trial balance</p> <p>1) We may have to debit wage expenses and credit wages payable if there are unpaid wages left at the end of the period.</p> <p>2) We may have to debit inventory expense and credit inventory to account for used up (sold) inventory.</p> <p>3) We may have to debit depreciation expense and credit accumulated depreciation for property and equipment.</p>

	Beginning Balance (February 28,2009)	1. Purchasing Inventory	2. Incur Factory Wages	3. Sell inventory for cash and on account	4. Pay for inventory	5. Collect receivables	6. Incur SG&A (cash and payable)	7. Pay wages franchise fee	8. Receive franchise fee	9. Purchase PPE	10. Dividends declared and paid	11. All other transactions	Unadjusted trial balance
Cash and cash equivalents	\$ 1,253,947.00			\$17,000,000	\$ (8,200,000)	\$4,100,000	\$ (2,000,000)	\$ (6,423,789)	\$ 125,000	\$ (498,832)	\$ (2,403,458)	\$ 790,224	\$ 3,743,092
Accounts receivable	4,229,733			5,000,000		(4,100,000)						(702,207)	4,427,526
Notes receivable, current	-											91,059	91,059
Inventories	4,064,611	\$7,500,000	\$6,000,000	(14,000,000)								(66,328)	3,498,283
Deferred income taxes	369,197											92,052	461,249
Dr. Other	224,378											(4,215)	220,163
Property and equipment, net	5,253,598									498,832		132,859	5,885,289
Notes receivable, less current portion	124,452											139,198	263,650
Goodwill, net	1,046,944												1,046,944
Intangible assets, net	183,135											(73,110)	110,025
Other	91,057											(3,007)	88,050
Accounts payable	1,074,643	7,500,000			(8,200,000)							503,189	877,832
Accrued salaries and wages	423,789		6,000,000					(6,423,789)					-
Other accrued expenses	531,941						3,300,000					(2,885,413)	946,528
Dividend payable	598,986										3,709	(1)	602,694
Deferred income	142,000								125,000			(46,062)	220,938
Deferred income taxes	827,700											66,729	894,429
Common stock	179,696											1,112	180,808
Additional paid-in capital	7,311,280											315,322	7,626,602
Retained earnings	5,751,017										(2,407,167)		3,343,850
Sales	-			22,000,000								944,017	22,944,017
Franchise and royalty fees	-											5,492,531	5,492,531
Cost of sales	-			14,000,000								693,786	14,693,786
Franchise costs	-											1,499,477	1,499,477
Sales & marketing	-						1,505,431						1,505,431
General and administrative	-											(261,622)	1,782,947
Retail operating	-						2,044,569						1,750,000
Depreciation and amortization	-						1,750,000						-
Interest income	-											(27,210)	(27,210)
Income tax expense	-											2,090,468	2,090,468
A = L + OE + R - E	-	-	-	-	-	-	-	-	-	-	-	-	-

		Unadjusted trial balance	12. Adjust for inventory count	13. Record depreciation	14. Wage accrual	15. Consultant's report	Pre-closing trial balance	16. Closing entry	Post-closing (ending) balance	Actual February 28, 2010 F/S figures
Dr.	Cash and cash equivalents	\$ 3,743,092					\$ 3,743,092		\$ 3,743,092	\$ 3,743,092
	Accounts receivable	4,427,526					4,427,526		4,427,526	4,427,526
	Notes receivable, current	91,059					91,059		91,059	91,059
	Inventories	3,498,283	\$ (216,836)				3,281,447		3,281,447	3,281,447
	Deferred income taxes	461,249					461,249		461,249	461,249
	Other	220,163					220,163		220,163	220,163
	Property and equipment, net	5,885,289		\$ (698,580)			5,186,709		5,186,709	5,186,709
	Notes receivable, less current portion	263,650					263,650		263,650	263,650
	Goodwill, net	1,046,944					1,046,944		1,046,944	1,046,944
	Intangible assets, net	110,025					110,025		110,025	110,025
Cr.	Other	88,050					88,050		88,050	88,050
	Accounts payable	877,832					877,832		877,832	877,832
	Accrued salaries and wages	-			\$ 646,156		646,156		646,156	646,156
	Other accrued expenses	946,528					946,528		946,528	946,528
	Dividend payable	602,694					602,694		602,694	602,694
	Deferred income	220,938					220,938		220,938	220,938
	Deferred income taxes	894,429					894,429		894,429	894,429
	Common stock	180,808					180,808		180,808	180,808
	Additional paid-in capital	7,626,602					7,626,602		7,626,602	7,626,602
	Retained earnings	3,343,850					3,343,850	\$ 3,580,077	6,923,927	6,923,927
Dr.	Sales	22,944,017					22,944,017	(22,944,017)	-	22,944,017
	Franchise and royalty fees	5,492,531					5,492,531	(5,492,531)	-	5,492,531
	Cost of sales	14,693,786	216,836				14,910,622	(14,910,622)	-	14,910,622
	Franchise costs	1,499,477					1,499,477	(1,499,477)	-	1,499,477
	Sales & marketing	1,505,431					1,505,431	(1,505,431)	-	1,505,431
	General and administrative	1,782,947			639,200		2,422,147	(2,422,147)	-	2,422,147
	Retail operating	1,750,000			6,956		1,756,956	(1,756,956)	-	1,756,956
	Depreciation and amortization	-		698,580			698,580	(698,580)	-	698,580
	Interest income	(27,210)					(27,210)	27,210	-	(27,210)
	Income tax expense	2,090,468					2,090,468	(2,090,468)	-	2,090,468
	A = L + OE + R - E	-	-	-	-	-	-	-	-	-

Rocky Mountain Chocolate Factory		
Income Statement		
For the year ended February 28, 2010		
<b>Revenues</b>		
Sales		\$ 22,944,017
Franchise and royalty fees		5,492,531
<b>Total revenues</b>		<b>\$ 28,436,548</b>
<b>Costs and Expenses</b>		
Cost of sales		14,910,622
Franchise costs		1,499,477
Sales & marketing		1,505,431
General and administrative		2,422,147
Retail operating		1,756,956
Depreciation and amortization		698,580
<b>Total costs and expenses</b>		<b>\$ 22,793,213</b>
<b>Operating Income</b>		<b>5,643,335</b>
<b>Other Income (Expense)</b>		
Interest expense		-
Interest income		27,210
<b>Other, net</b>		<b>\$ 27,210</b>
<b>Income Before Income Taxes</b>		<b>5,670,545</b>
<b>Income tax expense</b>		<b>2,090,468</b>
<b>Net Income</b>		<b>\$ 3,580,077</b>
<b>Basic Earnings per Common Share</b>		<b>0.60</b>
<b>Diluted Earnings per Common Share</b>		<b>0.58</b>
<b>Weighted Average Common Shares Outstanding</b>		<b>6,012,717</b>
<b>Dilutive Effect of Employee Stock Options</b>		<b>197,521</b>
<b>Weighted Average Common Shares Outstanding, Assuming Dilution</b>		<b>6,210,238</b>



Rocky Mountain Chocolate Factory		
Balance Sheet		
As of February 28, 2010		
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents		\$ 3,743,092
Accounts receivable		4,427,526
Notes receivable, current		91,059
Inventories		3,281,447
Deferred income taxes		461,249
Other		220,163
<b>Total Current Assets</b>		<b>\$ 12,224,536</b>
<b>Property and equipment, net</b>		<b>5,186,709</b>
<b>Other Assets</b>		
Notes receivable, less current portion		263,650
Goodwill, net		1,046,944
Intangible assets, net		110,025
Other		88,050
<b>Total other assets</b>		<b>\$ 1,508,669</b>
<b>Total Assets</b>		<b>\$ 18,919,914</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current Liabilities</b>		
Accounts payable		877,832
Accrued salaries and wages		646,156
Other accrued expenses		946,528
Dividend payable		602,694
Deferred income		220,938
<b>Total Current Liabilities</b>		<b>\$ 3,294,148</b>
<b>Deferred income taxes</b>		<b>894,429</b>
<b>Total Liabilities</b>		<b>\$ 4,188,577</b>
<b>Stockholders Equity</b>		
Common stock		180,808
Additional paid-in capital		7,626,602
Retained earnings		6,923,927
<b>Total Stockholders' Equity</b>		<b>\$ 14,731,337</b>
<b>Total Liabilities and Stockholders Equity</b>		<b>\$ 18,919,914</b>

	1. Purchasing Inventory	2. Incur Factory Wages	3. Sell inventory for cash and on account	4. Pay for inventory	5. Collect receivables	6. Incur SG&A (cash and payable)	7. Pay wages	8. Receive franchise fee	9. Purchase PPE	10. Dividends declared and paid
Operating, Investing, or Financing	Operating	Operating	Operating	Operating	Operating	Operating	Operating	Operating	Investing	Financing

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed

Adam Weekley

### Case 3: Scenarios

By

Adam Weekley

In this case, students debated with the whole class regarding certain scenarios that Professor Dickinson's students often find themselves maneuvering as they begin to wrap up their college careers. In the first scenario the class debated, the hypothetical student intended to go to law school before he went out to pursue a career in tax accounting because he thought it would be more lucrative. The second debate revolved around using the reputation of the Patterson School of Accountancy as a springboard into a career in Investment Banking or other similar careers outside of accounting. The final debate focused on a specific email Dr. Dickinson had received from a student in the past. The student had done his internship in Washington D.C., but he emailed her to see if she would be willing to help him get his job offer transferred to Dallas after he had completed his internship. Finally, Dr. Dickinson wrapped up the debates with some important guidance on transparency with the firms and some basic etiquette the students should be sure to follow while they go through the recruiting and career pursuit process.

Quite frankly, this was the most informative of Professor Dickinson's classes I had yet attended. I learned many things about the recruiting process I am about to undergo that will likely change the way I approach the recruiters and the process as a whole. Originally (and naively), I thought I would be able to get a public accounting internship the Spring of my senior year in order to test out the accounting profession. Most likely, though, I assumed I would matriculate into medical school the next fall. Learning about the process, though, taught me how important it is to the firms that they retain their interns as full-time employees. I realize that, much sooner than I thought, I will need to decide whether I am going to fully pursue a career in medicine or a career in accounting. Also, after hearing Dr. Dickinson discuss some of the various

career paths following an internship and starting a job with a public accounting firm, I am feeling a little more inclined towards the accounting career path.

1. In the first scenario, the student in question says that he wants to go to law school after he gets his accounting degree. The student thinks that he will make more money if he goes and works for a law firm as a tax accountant instead of going the masters in accountancy and CPA route. Half of the class, agreeing with the student in question, argued that it would be better to go to law school to become as knowledgeable as possible about tax law. Following an advanced knowledge of tax law, this half of the class thought that the student would be able to make more money working for a law firm with a JD than an accounting firm with just a CPA. The half of the class that disagreed, though, pointed out the fact that the student would have to commit three years and lots of money to law school. They also pointed out that tax attorneys don't even end up making that much more money than someone who goes into public accounting, especially in the long term.

Initially, I was on the side of the student. It made sense that he should want to go and become as specialized as possible in tax in order to have the most successful and lucrative career. By the end of the argument, though, I had learned that the law school path did not provide quite the career advantage that I thought. Quite frankly, my misjudgment was on the side of the public accountant's career path. I didn't realize there was such a large potential to work one's way up through a public accounting firm or to be hired out by other companies from a

public accounting firm. I also did not realize how much money could be made going the public accounting route.

2. The following scenario discussed a student who is majoring in accounting at Ole Miss just to get a foot in the door for other careers. He thinks that being in the Patterson School will provide him a large advantage in getting hired as a big Investment Banker or something along those lines. This issue also divided the class. Some students took it a step further and defended the argument that the student in question should also apply for a public accounting internship, even if he had no intention of working with the firm, or even in the field of public accounting, after graduation. On the other hand, many students argued against this position with the point that this decision was not respecting the students who actually wanted to pursue a career in public accounting. Again, before the discussion, I was leaning toward agreeing with the student in question, but, after learning more about the internship process, I have to argue that taking internship spots with no intention of following up with the firm after graduation is a problem. Not only does this disrespect the other students vying for those internships, but this deception also mars the Patterson School's reputation, harming future students' prospects. This is another important consideration I did not realize before this particular class period.
3. The final scenario forced me to consider, in particular, the location of a potential internship and where I might want to spend the rest of my life. The student in this

scenario sent Dr. Dickinson an email seeking assistance in moving his job offer from the location of his internship (Washington D.C.) to Dallas. Many in the class defended this student on the grounds that the city could have been much different than expected, resulting in his wishing to live elsewhere after graduation. I, once again, was originally on the side defending the student. After further debate, though, Dr. Dickinson convinced me that due diligence would require extensive research on the location of one's internship before choosing a certain city. Then, even if I wasn't to enjoy the city during my internship, I ought to give it several years to give it a chance to grow on me before deciding to request a transfer. I hadn't realized that I would need to be deciding where I wanted to live following graduation so soon, but I have been giving it lots of thought ever since she brought this up in class.

I learned a lot of new information during these debates, as might be evident in the discussion. I have a lot to reconsider in a very short time frame regarding my career. I will need to decide between pursuing medical school or a career in accounting, and I will need to make this decision in the very near future. Regardless of the answer to the prior question, I will also need to consider where I want to live after graduation. This discussion was a kind of wake-up call, reminding me how soon graduation is approaching and how many tough decisions I'll need to make before then.

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed

Adam Weekley



Case 4

Generic Bank: Accounting for Debt Securities Sales and Impairments

By

Adam Weekley

In this case, students read information about Generic Bank and its financial situation. A significant portion of the bank's assets are tied up in available for sale securities. The students are required to learn about conditions resulting in a need to report an impairment loss on securities like these. The students then consider several different perspectives and whether or not these securities would need to be recorded as impairment losses in these scenarios. The students must evaluate the conflicting interests and subjectivity of certain assessments of future needs for the bank and how these conflicting interests may impact the financial statements.

In considering and responding to this case, I learned about the valuation of available for sale securities and, more importantly, about some scenarios in which the subjective nature of certain financial valuations can come into play in the financial statements. I was unaware of the complex evaluations that must go into determining what securities are impaired and how much they should be impaired. I learned the basics of determining this impairment and why it needs to be done. I also considered how certain decisions in the making of the financial statements are absolutely subjective. I realized that external auditors, in particular, need to be especially aware of these valuations and consider the conflicting interests at play.

- 1. Assume that Generic Bank does sell the aforementioned securities shortly after year end in early 20x3. Does Generic Bank have an impairment loss on the seven securities designated above in 20x2?**

Generic Bank does need to include an impairment loss in their 20x2 financial statements on the seven securities discussed. They need to include this impairment loss in 20x2, even though they haven't yet sold the securities, because Joshua, Generic Bank's CFO, is considering selling the securities at the end of the year. This intention results in their having to report the unrealized loss as an impairment based on the rule stated in ASC 326-30 that says "...if the bank is not able to assert that it has the intent and ability to hold the securities until unrealized losses have recovered, then the securities would be deemed impaired and written down to their fair value." Considering the fact that the securities are not going to regain all of the unrealized loss in the period of time between the end of the year and when Joshua decides to sell the securities, these unrealized losses, without a doubt, need to be reported as impaired and written down to their fair value.

- 2. Assume that Generic Bank does sell the aforementioned securities shortly after year end in 20x3. Does Generic Bank have an impairment loss on securities other than the seven securities sold? If so, how would you determine the extent of the impairment?**

Generic Bank likely does have an impairment loss on securities other than the seven securities they sold in the beginning of 20x3. Considering the quantity of

mortgage backed loans in their possession (having a fair value of roughly 3.5 billion), despite the bank's claims, it is likely that at least some decline in the value of their securities is due to credit loss. It is unlikely that so many homeowners have kept up with their debt. According to ASC 326-30, "If credit losses are present, then a security would be impaired with an impairment charge equal to the extent of the credit loss (capped by the fair value of the security)." Determining the extent of this impairment due to credit loss would require a very complex analysis, so, instead, I will focus on the intent and ability of Generic Bank to hold the securities with an unrealized loss until they regain their value. As described in ASC 326-30, as long as the bank does not intend to sell the securities until they regain their value, they do not have to mark them down as impaired. The bank does not say that they intend to sell any of the other securities until they regain their value, but the article does mention the bank often requires increases in liquidity on short notice. This might be a cause to consider impairing the securities, but the article also mentions that the bank has other means of raising the liquidity, if necessary. For this reason, barring the potential credit loss, I would determine that there were no further impairment losses on Generic Bank's available for sale securities.

- 3. Does your answer change if you assume the role of Heather Herring, the external auditor? Does your answer change if you assume the role of a bank regulator? What other factors might an external auditor or regulator consider in making their determination?**

My answer would be quite unlikely to change, regardless of the role I assume.

My answer would not change because I believe, even working for the bank, I would have made the most honest, accurate determination of our impairment loss as possible. I understand that certain conflicts of interest in subjective assessments, like determining the chances that Generic Bank will be required to sell these securities, may be nearly impossible for a human being to suppress completely, though. For this reason, if I were an external auditor or a bank regulator, I would be more critical of the bank's liquidity and potential needs for cash in the near future. Both the external auditor and the bank regulator should require more research into Generic Bank's past liquidity needs during the period and how much cash the bank could access to reach these needs. Having external perspectives, they should be able to make a more objective decision in determining if there is any possibility of the bank's needing to sell securities in order to reach liquidity needs. They also might need to consider other factors, like potential changes in interest rate or market health and trends in general. They could then take all of this information into account to ensure that the bank is making accurate determinations of impairment losses.

**4. How would your assessment of the existence of an impairment in both requirements 1 and 2 change if the securities sold had been collectively in a net gain position? What if all the securities sold were in gain positions?**

Even if the collection of all seven securities had been in a net gain position, any individual securities that had an impairment loss would need to be marked down as having an impairment loss. The unrealized gain from the rest of the securities would go through to comprehensive income, but the impairment of any securities will still exist and need to be accounted for accordingly. If all the securities sold were in the gain position, on the other hand, then there would be no need to report any impairment loss. Since the bank was not considering selling any securities while their fair value was below their amortized cost, there would be no impairment.

**5. Assume the Generic Bank does sell the aforementioned securities shortly after year end in early 20x3. Does Generic Bank have an impairment loss on securities other than the seven securities sold?**

Under the new circumstances given, Generic Bank would need to report an impairment loss on securities other than the seven sold. The reason for this refers, once again, to ASC 326-30, which states that "...if the bank is not able to assert that it has the intent and ability to hold the securities until unrealized losses have recovered, then the securities would be deemed impaired and written down to their fair value." The new circumstances present two reasons that these securities would need to be impaired based on ASC 326-30. First, the bank now wants to

improve capital ratios through the reduction of risky assets, in which some of these securities would certainly be included. Therefore, they would not be able to assert that they have no intent to sell any securities. In addition, the bank now is less capitalized and has less access to borrowing money to meet liquidity purposes. These facts significantly increase the possibility that the bank will need to sell some of these securities in order to keep operating as they wish to. The financial team would need to carefully evaluate which of their available for sale securities would be the first to sell and impair them accordingly.

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed

Adam Weekley

Case 5: City Selection Case

By

Adam Weekley



In this case, students were required to determine and analyze the top two cities in which they are interested in starting their careers. Once naming the top two cities on their lists, the students had to answer a broad array of questions about each city. These questions forced the students to research a wide variety of information about the cities, ranging from information about local grocery stores, to the typical climates, all the way to the crime rates and areas of town that they should avoid. Then, once answering all of these questions, each student had to come up with an operating budget based off their projected rent and other living expenses. Finally, the students had to digest all the information they had just learned and reevaluate whether or not the two cities were still the two at the top of their list.

This case required me to do specific research about each of my top two cities, Denver and Salt Lake City, that I had not done before. The first thing that stands out to me that I learned is that the rent in each of these cities is much lower than I thought it would be. Another thing that surprised me was how cheap round-trip flights from Tampa to each of these cities are. I even had things to learn about the crime rates. Each city is safer than I would have assumed. Public transportation, despite what I would have thought, in each of these cities, won't be necessary for me either. I will be able to get around quite well in my vehicle. Of everything surprising that I learned doing this research, I did not learn anything that changed my mind about where I want to pursue a career. Quite frankly, the research only made me more confident that I have the right idea with my list of cities in which I want to work.

My first two choices of cities in which I'd like to start my career are Denver and then Salt Lake City.

**1. What is the population?**

The population of Denver is roughly 700,000 people, and the population of Salt Lake City is about 200,000.

**2. Describe the climate and seasonal fluctuations.**

In Denver, the average temperature over the course of a year fluctuates quite a bit. In the winter, the daily low can tend to be below twenty degrees Fahrenheit, with the average temperature generally in the low thirties. In the summer, though, the highs can often be in the eighties and low nineties, with the average temperature being in the low seventies. Salt Lake City, similarly, has an average temperature around thirty in the winter, with lows averaging in the twenties. Summers are also similar to Denver with the average temperature in the seventies and the average highs in the mid to upper eighties. These climates play a part in why I want to relocate from Tampa to the West in the first place.

**3. Describe the city's topography, scenery, and other geographic or geological features of the area in which the city is located. Include pictures where appropriate.**

Each city is nestled in very close to the Rocky Mountains. The cities themselves are relatively flat, but very close to each are mountain ranges. On the East side of Denver, though, are the plains of the Midwest (the Rockies are to the West). Salt Lake City has the Rockies to its East and South mostly, with the Great Salt Lake just to the Northwest of the city.



**Figure 1: Map Showing Denver and Salt Lake City**

**4. What are the individual tax rates within the city (e.g., consider federal, state and local income tax, property tax, and any other taxes you'd be likely to pay. Quantify what this means based on a starting salary of approximately \$50,000/year)?**

The effective federal, FICA, state, and local income tax rates for that level of income in Denver are 11.28 percent, 7.65 percent, 4.63 percent, and 0 percent, respectively, resulting in a net income after taxes of just below \$40,000. The effective federal, FICA, state, and local income tax rates for that level of income in Salt Lake City are 11.28 percent, 7.65 percent, 4.70 percent, and 0 percent, respectively, resulting in a

net income after taxes of, also, just below \$40,000. The property tax in Denver is roughly 0.7 percent and in Salt Lake City it is roughly 0.75 percent.

### **5. What transportation hubs are in the city?**

In Denver, the transportation hubs are Union Station and Civic Center Station. It is relatively easy to orient oneself in Denver because the Rocky Mountains are normally visible in the West as a point of reference. In Salt Lake City, the main transportation hub is the Salt Lake City Intermodal Hub, also known as Salt Lake Central.

### **6. What are the city's most prevalent industries?**

The most prevalent industries in Denver are construction, professional services, and retail trade, each of which make up over 10 percent of the all industries in Denver. In Salt Lake City, the three most prevalent industries are educational services, manufacturing, and professional services. The three of these industries combined make up roughly 30 percent of Salt Lake City's industries.

### **7. Describe the quality of the city's healthcare?**

Each Denver and Salt Lake City have great health care. Denver is the main medical center of the Rocky Mountains, having nearly thirty major hospitals in the area. Salt Lake City also has quality health care based around the hospital associated with the

medical school at University of Utah. The people in Salt Lake City are some of the healthies in the country.

**8. What types of crime are common within the city and where are the locations within the city to avoid?**

The most prevalent crime in each city (and probably every other city in America) is theft. Although, in Salt Lake City, there are roughly three times as many cases of theft than in Denver per 100,000 people. Another interesting metric, despite the theft disparity, is that Denver tends to have more murders per 100,000 people than Salt Lake City does. There are some areas in North Denver to avoid, but there are not a ton of rough areas in Denver. The same with Salt Lake City, although Glendale and Fairpark are the less safe of the neighborhoods.

**9. Based on where you see yourself living for the first three years, how much rent do you expect to pay? Back up this assertion with sample properties from each location (including pictures). Describe the square footage, amenities, need for a roommate, availability of parking, etc**

In Denver, I'd expect to pay roughly \$1,000 a month in rent. One of the places I found on Zillow is a two bedroom that's about 1,000 square feet for a total of \$1,800 a month. This apartment (Commons Park West) includes parking, a swimming pool, a gym, and even package services. The second one I found in Denver, called Westend

Apartments, also is a two bedroom, but this one costs just over \$2,000 a month total.

These apartments are just over 1,000 square feet, and they include access to a game room, a swimming pool, a carport, and also a gym.



**Figure 2: Commons Park West Apartments**



**Figure 3: Westend Apartments**

In Salt Lake City, though, I should have to pay a little bit less. I will roughly be paying \$850 a month, assuming I have just one roommate. The first apartment I found, known as the Lotus Apartments, costs around \$1,600 a month and has approximately 900

square feet of living space. This apartment building also includes a hot tub, a fitness center, and reserved parking spaces. The other option I was able to come up with is named 4<sup>th</sup> West apartments. These apartments cost about \$2,000 a month for just over 1,000 square feet. These apartments also include a swimming pool, a game room, a business center, and a garage.



**Figure 4: Lotus Apartments**



**Figure 5: 4<sup>th</sup> West Apartments**

**10. What is the typical mode of commuting? Based on your answers identified in the prior question, what are your likely commute times?**

In Denver, the commute from each apartment would be between 1 and 2 miles each day. I could take the bus if I chose to, which would take about 20 minutes, but I could also drive if I chose to. Depending on traffic, the drive could take anywhere from 10 minutes to 30 minutes. Both of the apartment options I found in Salt Lake City are roughly a mile away from where I'd imagine I will be working. I will be able to walk or drive, depending on the weather from both of these places in Salt Lake City. The commute times will range from 5-15 minutes depending on traffic if I drive. The commute time will probably be between 15-20 minutes if I walk.

**11. Where will you do your grocery shopping?**

In Denver, I'd do my grocery shopping at the Sam's Club, which is approximately a 15-minute drive from each of the potential apartment options. In Salt Lake City, I'd do my grocery shopping at the Trader Joe's less than 2 miles away from each apartment.

**12. How will you do your laundry?**

In Denver, each apartment option has a washer and dryer in the unit, so I would just do my laundry like there like normal. I would get my dry cleaning done at Revolution Cleaners, right near the apartment. Both apartments in Salt Lake City also have washer and dryers in the building, so I'd do my laundry at home just like I've been



doing here in Oxford. I would get my dress clothes dry cleaned a couple times a month as well at Henries Dry Cleaners near work.

**13. Name at least three civic, religious, or charitable organizations you would like to be active in for each city?**

In each city, I would be active in the nearest Episcopal Church. I would also like to be active in the local chapters of habitat for humanity. A third organization of interest to me in Denver would be the Bicycle Colorado organization because I love to ride my bike. In Salt Lake City, my third choice of organization would be the Mountain Trails Foundation because I love to go hiking, and this organization is focused on promoting local recreational trails.

**14. What are the sports, entertainment, or recreational activities that you would be most likely to engage in within the city. Name at least five activities.**

In each Denver and Salt Lake City, I would do similar activities. I will go on runs several times a week, mountain bike in the summer, fall, and spring, and go to the shooting range in each Denver and Salt Lake City. In Denver, I would also attend Rockies baseball games and Broncos football games. In Salt Lake City, I would go to Utah Jazz basketball games and participate in an adult men's softball league.

**15. What are the modes of traveling back to your hometown from this city? What is the average cost you'd incur for each trip back home?**

I would need to fly home to Tampa from each of these places. A round trip plane ticket from Denver to Tampa is roughly going to cost me \$350. A round trip plane ticket from Salt Lake City to Tampa will cost me about \$450. Denver has direct flights to and from Tampa, but Salt Lake City does not.

**16. Based on your findings, develop a model monthly operating budget for each city for Year 2, assuming that with bonuses for being a high performer, your annual salary is \$60,000.**

Denver				Salt Lake City			
Gross Salary	\$ 60,000			Gross Salary	\$ 60,000		
401K Contribution	\$ 7,200			401K Contribution	\$ 7,200		
Net Taxable Salary	\$ 52,800			Net Taxable Salary	\$ 52,800		
Less: Income Tax	\$ 12,020			Less: Income Tax	\$ 11,440		
Annual salary after taxes	\$ 40,780		Remaining Salary	Annual salary after taxes	\$ 41,360		Remaining Salary
Monthly Salary	\$ 3,398			Monthly Salary	\$ 3,447		
Less:				Less:			
Rent	\$ 1,000		\$ 2,398	Rent	\$ 850		\$ 2,597
Groceries	\$ 250		\$ 2,148	Groceries	\$ 250		\$ 2,347
Gas	\$ 150		\$ 1,998	Gas	\$ 150		\$ 2,197
Healthcare	\$ 250		\$ 1,748	Healthcare	\$ 250		\$ 1,947
Eating out	\$ 300		\$ 1,448	Eating out	\$ 300		\$ 1,647
Clothes and personal products	\$ 300		\$ 1,148	Clothes and personal products	\$ 300		\$ 1,347
Entertainment	\$ 350		\$ 798	Entertainment	\$ 350		\$ 997
Misc	\$ 500		\$ 298	Misc	\$ 500		\$ 497
Other				Other			
Saving/Investment	\$ 298		\$ 0	Saving/Investment	\$ 497		\$ (0)

**17. Finally, based on your full analysis, determine whether you still want to live in both cities, and if so, which one is your preferred city and why?**

Based on my analysis, I would still like to live in both cities. Denver is still my preferred city. Despite having a slightly higher cost of living, Denver is a larger city and

it is closer to home. I don't want to live in a huge city, but I would prefer Denver to Salt Lake City in population size. Denver is also closer to home with cheaper flights than from Salt Lake City. Salt Lake City is a close second, but Denver is still my first choice of city in which I'd like to pursue my career.

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“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed

Adam Weekley

Case 6: WorldCom, Inc.

By

Adam Weekley

In this case, students were required to consider and answer questions about WorldCom's accounting fraud at the beginning of the twenty first century. The financial statements for this company were given, and the students were instructed to review the specific accounting rules that were bent in order to alter the statements of WorldCom. As the students researched the rules and described the ways the rules were broke, they had to consider the specific discretion that must be used when determining whether to capitalize or expense certain costs. The students had to determine exactly what difference in WorldCom's financial statements the accounting fraud made. This exercise brought to the students' attention how important it is to carefully abide by GAAP and what repercussions can occur to those that do not.

I learned about the significance of cost capitalization during this case. I did not realize how significant of a difference the capitalization of some costs could make. To see such a large net income turn into a net loss, once the proper consideration of costs has been made, is quite eye-opening. This case provides an example of how discretion can play a large part in the role of an accountant. Accountants must thoroughly understand the rules and what costs can be capitalized in what circumstances. They also need to be aware how serious of an impact bending the rules can have. Reading about the situation WorldCom's controller found himself in after consenting to accounting practices that he knew were fraudulent really reinforces in my mind how serious GAAP is and what consequences occur when someone breaks these guidelines.

**a. FASB Statement of Concepts No. 6 (a replacement for SCON No. 3), Elements of Financial Statements, describes the building blocks with which financial statements are constructed.**

- i. Explain, in your own words, how SCON 6 defines "asset" and "expense."**

An asset, as defined by SCON 6, is something owned by an entity that provides some probable future benefit to that entity. This probable future benefit takes the form of some sort of increase in future net cash inflows. An expense, on the other hand, is an actual or an expected outflow of cash which occurs because of the firm's central operations.

**ii. In general, when should costs be expensed and when should they be capitalized as assets?**

Costs should be expensed when they do not hold any future value potential. Costs should be capitalized when they still have the potential to offer or continue offering some future benefit in the form of cash inflows.

**b. What becomes of “costs” after their initial capitalization? Describe, in general terms, how the balance sheet and the income statement are affected by a decision to capitalize a given cost.**

After a cost is capitalized (is classified as an asset), they will either be amortized or depreciated over an extended period of time. As the asset is used up or decreases in value, the firm must acknowledge this in the form of amortization or depreciation expenses. In general, once a cost is capitalized, the cost is considered an asset, the value of which will slowly be decreased over a period of time. As the value of the capitalized asset decreased, the decrease in value attributed to a given period will be considered an expense in that period. This is a slow conversion from an asset on the balance sheet to becoming an expense on the income statement through the form of depreciation or amortization expense.

**c. Refer to WorldCom's statement of operations. What did the company report as line costs for the year ended December 31, 2001? Prepare the journal entry to record these transactions for the year. Explain in your own words, what these "line costs" are.**

For the year ended December 31, 2001, WorldCom reported \$14,739 million as the line costs charge to operating expenses.

Line cost expense	xxx
Accounts payable	xxx

These line costs are the fees that were charged to WorldCom in exchange for the use of other firms' local networks. Networks would include fiber optic cables and other methods of information transmission used, but not owned, by WorldCom during the period.

**d. Refer to the Wall Street Journal article. Describe the types of costs that were improperly capitalized at WorldCom. Explain, in your own words, what transactions give rise to these costs. Do these costs meet your definition of assets in part a above?**

The costs that were improperly capitalized were charges associated with WorldCom's use of local networks. WorldCom, a long-distance communication provider, used the communication networks of local companies to complete local communication. These companies charged WorldCom for the use of their lines. These costs do not meet the definition of an asset as laid out above. An asset offers some future probable benefit, but these charges do not offer a future



benefit. These charges directly fall under the definition of an expense because the benefit resulting from the cost had already been completely used.

**e. Prepare a single journal entry to record the improperly capitalized line costs of \$3.055 billion for the year. Where did these costs appear on the balance sheet? Where on the statement of cash flows?**

Journal Entry in millions of dollars

Property, Plant, and Equipment	3,055	
Accounts Payable		3,055

These costs appeared under “PPE” on the balance sheet, and they fell under the “capital expenditure” category on the statement of cash flows.

**f. In a sworn statement to the Securities and Exchange Commission, WorldCom revealed details of the improperly capitalized amounts (in millions) in 2001: \$771 in the first quarter, \$610 in the second quarter, \$743 in the third quarter, and \$931 in the fourth quarter. Assume that WorldCom planned to depreciate these capitalized costs over the midpoint of the range for transmission equipment as disclosed in note 1. Further assume that depreciation begins in the quarter that assets are acquired (or costs capitalized). Calculate**

**the related depreciation expense for 2001. Prepare the journal entry to record this depreciation.**

The amount capitalized in the first quarter (\$771 million) would, assuming a life of 22 years and no salvage value, depreciate by roughly \$35 million every year. The amount capitalized at the end of the second, third, and fourth quarters (\$610, \$743, and \$931 million, respectively), under the same assumptions as above, would depreciate by about \$28, \$34, and \$42 million per year, respectively. Only a portion of each of these would be taken into consideration on the 2001 income statement, though, based on the quarter in which they were capitalized. Those capitalized during the first quarter would be charged for a year of depreciation, those capitalized in the second would be charged three-quarters of a year of depreciation, and so on with the third and fourth quarters. The charges from first quarter capitalizations would be \$35,045,455, from second quarter capitalizations would be \$20,795,455, from third quarter capitalizations would be \$16,886,364, and from fourth quarter capitalizations would be \$10,579,545. This results in a total depreciation expense for 2001 of \$83,306,819.

Journal Entry in millions of dollars

Depreciation expense	83,307
Accumulated depreciation	83,307

**g. Use your answers to parts e and f above, to determine what WorldCom's net income would have been in 2001 had line-costs not been improperly capitalized. Use 35% as an**

**approximation of WorldCom's 2001 marginal income tax rate, in your calculations. State any other assumptions you make. Is the difference in net income material?**

When WorldCom capitalized all of those expenses, they increased their income before taxes by the difference of between the improperly capitalized expenses (\$3,055,000,000) and the depreciation expenses (\$83,306,819) charged to the improperly capitalized expenses. This increase in income before taxes is \$2,917,693,181. Since their reported income before taxes was \$2,393,000,000, the difference would have been enough to result in a net loss. The net loss before tax deductions would have been \$578,693,181. After tax deductions, before taking minority interests into account, the loss should have been \$376,150,568 (net loss before tax\*(1-T)). Finally, including minority interests of \$35,000,000, the net income should have been (\$341,150,568). Since they reported a net income of \$1,384,000,000 when they actually should have reported a loss of \$341,150,568, the difference is \$1,725,150,568. This difference of almost 2 billion dollars is absolutely material. Especially because it changes their net income of over a billion dollars to a loss of half a billion dollars.

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed

Adam Weekley

## Case 7: Starbucks Corporation – Understanding Financial Statements

By

Adam Weekley

In this case, students were required to analyze the financial statements of a large public company, Starbucks. They had to go onto the SEC's website, gather Starbucks' financial statements, and answer some specific questions about Starbucks' financial tendencies and the type of business that Starbucks is. Some questions required the students to consider the actual process that goes along with an audit. Others asked very specific questions regarding the source of Starbucks' financing, the estimates that come into play in their financial statements, and several other nuances that are worth noting. Overall, the students, in completing this case, got a brief look into what materials come out of a real-world audit and what particular things external users might pay attention to when looking over a corporation's financial statements.

I learned some basic skills about reviewing a corporation's financial statements in order to attempt to evaluate their future profitability. I would take special care to consider the year to year profitability and to analyze, in particular, deviations to the common trends. Profits or losses that are abnormal may not be as good (or bad) as they seem for the long term. Also, I learned about the value that can be found in the footnotes of the financial statements. The question that had us consider the estimates that go into certain lines provided some insight into where there might be some "flexibility" in reported numbers and why it is a good idea to review the footnotes. In general, though, the overarching takeaway for me came from reviewing the opinion letters. Reading these letters, though brief, puts the auditing process into perspective and reminds the student that the auditor does not actually make the financial statements. The combination of the opinion letters with answering the questions dovetail to emphasize the role of the auditor in ensuring the fair representation of a company's situation in the financial statements.

**a. What is the nature of Starbucks' business? That is, based on what you know about the company and on the accompanying financial statements, how does Starbucks make money?**

Starbucks generates revenues by purchasing the ingredients to make and sell coffee, tea, and some food items in their stores. In addition to selling their food and drinks in their stores, they also sell them to other entities like grocery stores and convenience stores. In addition to food and drink, according to their financial statements, Starbucks also sells "coffee and tea products," which I assume to mean brewing paraphernalia and mug-type products.

**b. What financial statements are commonly prepared for external reporting purposes? What titles does Starbucks give these statements? What does "consolidated" mean?**

The financial statements commonly prepared for external reporting purposes are the income statement, the balance sheet, the statement of retained earnings, and the statement of cash flows. Starbucks calls these, respectively, the consolidated statements of earnings, the consolidated balance sheets, consolidated statements of equity, and consolidated statements of cash flows. Consolidated just refers to the fact that the statements include any consolidated subsidiaries of Starbucks.

**c. How often do publicly traded corporations typically prepare financial statements for external reporting purposes?**

Publicly traded companies typically prepare financial statements every quarter, or every three months.

**d. Who is responsible for the financial statements? Discuss the potential users of the Starbucks financial statements and the type of information they are likely interested in.**

Both the company in question and the external auditors are responsible for the financial statements. The company in question prepares them and the external auditor evaluates them and expresses their opinion on their accuracy. Companies and individuals considering investing in Starbucks would make use of their financial statements. They would likely be interested in their profitability numbers, the source of their financing (through debt or equity), and maybe their tendency to pay dividends.

**e. Who are Starbucks' external auditors? Describe the two "opinion" letters that Starbucks received in 2013. In your own words, what do these opinions mean? Why are both opinions dated several months after Starbucks' year-end?**

Starbucks' external auditors are Deloitte & Touche. The two "opinion" letters that Starbucks received address what the external auditors did when they audited Starbucks. The letters then present Deloitte's opinion on the faithful representation of Starbucks'

financial position by their financial statements and their opinion on the strength Starbucks' internal controls. Deloitte's Seattle office reported the opinion, which confirmed a lack of any material misstatements and the presence of sound internal controls. To me, these opinions mean that the financial statements accurately depict what they intend and need to depict. These are dated several months after the year-end because Deloitte needed adequate time to evaluate and verify the financial statements and Starbucks' internal controls.

**f. Use a spreadsheet to construct common-size income statements (which Starbucks calls statements of earnings) and balance sheets for 2013 and 2012. Common-size income statements scale each income statement line item by total net revenues (sales). Common-size balance sheets are created by dividing each figure on a given year's balance sheet by that year's total assets, thereby creating a balance sheet on a "percent of assets" basis. You will use these common-size statements in answering several of the questions below. (Starbucks' investor relations website—[investor.starbucks.com](http://investor.starbucks.com)—contains a link to SEC filings. The company's Form 10-K can be found under annual filings and contains an Excel spreadsheet with financial statement data that may be helpful in creating the common-size statements).**



<b>Consolidated Statements Of Earnings</b> <b>In Millions, except Per Share data,</b> <b>unless otherwise specified</b>	<b>12 Months Ended</b>			
	<b>Sep. 29,</b> <b>2013</b>		<b>Sep. 30,</b> <b>2012</b>	
<b>Net revenues:</b>				
Company-operated stores	\$11,793.20	79%	\$10,534.50	79%
Licensed stores	1,360.50	9%	1,210.30	9%
CPG, foodservice and other	1,738.50	12%	1,554.70	12%
Total net revenues	14,892.20	100%	13,299.50	100%
Cost of sales including occupancy costs	6,382.30	43%	5,813.30	44%
Store operating expenses	4,286.10	29%	3,918.10	29%
Other operating expenses	457.2	3%	429.9	3%
Depreciation and amortization expenses	621.4	4%	550.3	4%
General and administrative expenses	937.9	6%	801.2	6%
Litigation charge	2,784.10	19%	0	0%
Total operating expenses	15,469	104%	11,512.80	87%
Gain on sale of properties	0	0%	0	0%
Income from equity investees	251.4	2%	210.7	2%
Operating income	-325.4	-2%	1,997.40	15%
Interest income and other, net	123.6	1%	94.4	1%
Interest expense	-28.1	0%	-32.7	0%
Earnings before income taxes	-229.9	-2%	2,059.10	15%
Income taxes	-238.7	-2%	674.4	5%
Net earnings including noncontrolling interests	8.8	0%	1,384.70	10%
Net earnings attributable to noncontrolling interest	0.5	0%	0.9	0%
Net earnings attributable to Starbucks	\$8.30	0%	\$1,383.80	10%
Earnings per share - basic	\$0.01	0%	\$1.83	0%
Earnings per share - diluted	\$0.01	0%	\$1.79	0%
<b>Weighted average shares outstanding:</b>				
Basic	749.3	5%	754.4	6%
Diluted	762.3	5%	773	6%
Cash dividends declared per share	\$0.89	0%	\$0.72	0%

Consolidated Balance Sheets (USD \$)	Sep. 29, 2013		Sep. 30, 2012	
In Millions, unless otherwise specified				
<b>Current assets:</b>				
Cash and cash equivalents	\$2,575.70	22%	\$1,188.60	14%
Short-term investments	658.1	6%	848.4	10%
Accounts receivable, net	561.4	5%	485.9	6%
Inventories	1,111.20	10%	1,241.50	15%
Prepaid expenses and other current assets	287.7	2%	196.5	2%
Deferred income taxes, net	277.3	2%	238.7	3%
Total current assets	5,471.40	48%	4,199.60	51%
Long-term investments	58.3	1%	116	1%
Equity and cost investments	496.5	4%	459.9	6%
Property, plant and equipment, net	3,200.50	28%	2,658.90	32%
Deferred income taxes, net	967	8%	97.3	1%
Other assets	185.3	2%	144.7	2%
Other intangible assets	274.8	2%	143.7	2%
Goodwill	862.9	7%	399.1	5%
TOTAL ASSETS	11,516.70	100%	8,219.20	100%
<b>Current liabilities:</b>				
Accounts payable	491.7	4%	398.1	5%
Accrued litigation charge	2,784.10	24%	0	0%
Accrued liabilities	1,269.30	11%	1,133.80	14%
Insurance reserves	178.5	2%	167.7	2%
Deferred revenue	653.7	6%	510.2	6%
Total current liabilities	5,377.30	47%	2,209.80	27%
Long-term debt	1,299.40	11%	549.6	7%
Other long-term liabilities	357.7	3%	345.3	4%
Total liabilities	7,034.40	61%	3,104.70	38%
<b>Shareholders' equity:</b>				
Common stock (\$0.001 par value) - authorized, 1,200.0 shares; issued and outstanding, 753.2 and 749.3 shares (includes 3.4 common stock units), respectively	0.8	0%	0.7	0%
Additional paid-in capital	282.1	2%	39.4	0%
Retained earnings	4,130.30	36%	5,046.20	61%
Accumulated other comprehensive income	67	1%	22.7	0%
Total shareholders' equity	4,480.20	39%	5,109	62%
Noncontrolling interests	2.1	0%	5.5	0%
Total equity	4,482.30	39%	5,114.50	62%
TOTAL LIABILITIES AND EQUITY	\$11,516.70	100%	\$8,219.20	100%
[1]	In conjunction with the change in reportable operating segments, we reclassified goodwill by segment as of October 2, 2011.			

**g. Refer to Starbucks' balance sheet for fiscal 2013 (the year ended September 29, 2013).**

**ii. What are Starbucks' major assets? Calculate the proportion of short-term and long-term assets for 2013. Does this seem appropriate for a company such as Starbucks?**

Starbucks' major assets are cash and cash equivalents, inventories, property plant and equipment, deferred income taxes, and goodwill. Short term assets make up 48 percent of total assets, and longer term make up 52 percent. The largest category is property, plant, and equipment, which makes sense because Starbucks' has lots of storefronts and seems to focus on quantity of small stores instead of having large stores. After property, plant, and equipment, cash and cash equivalents and inventories are the next largest, which also seems reasonable considering the nature of their business.

**iii. In general, what are intangible assets? What is goodwill? What specific intangible assets might Starbucks have?**

Intangible assets are assets that lack physical form, but they are not financial instruments. Goodwill is an intangible asset that represents the excess over the fair value of all the assets of a purchased company that a purchaser pays for said company. This means that goodwill can only be created upon the purchase of a company. Starbucks may have other intangible assets including trademarks, customer lists, certain licenses or permits, and franchises.

**iv. How is Starbucks financed? What proportion of total financing comes from non-owners?**

Starbucks is financed largely through debt. 61 percent of Starbucks' financing in 2013 came from non-owners, although a lot of this came from one line (accrued litigation charge). So, normally, it would seem like less than 61 percent of Starbucks' financing comes from debt

**h. Refer to Starbucks' statement of earnings for fiscal 2013 (the year ended September 29, 2013) and to the common-size income statement you developed in part f, above.**

**i. Review the revenue recognition policies of Starbucks discussed in Note 1 (Summary of Significant Accounting Policies). Does Starbucks record revenue when they receive cash from their customers (cash-basis accounting) or do they follow a different rubric (for example, accrual accounting)? How does Starbucks record revenue on stored value cards (i.e., gift cards)? What challenges in measuring revenue do you observe? That is, are there any significant judgments management needs to make in recording sales revenues at Starbucks?**

Starbucks does not follow a cash-basis accounting method for recognizing revenue. Instead, Starbucks' employs an accrual basis for accounting, recognizing revenue when it is considered to be earned. Starbucks normally accounts for stored value cards by recognizing the revenue when they are redeemed. Once stored value cards have been outstanding for a certain period of time, though, they will be considered unlikely to be

redeemed and moved into net income. This presents a challenge to management in that they have to estimate whether cards will be redeemed or not without concrete knowledge of what has happened to the card. The card could potentially still be redeemed, even after three years, because the cards do not have expiration dates. The management will have to make a judgement call on when the cards should be considered unlikely to be redeemed.

**ii. What are Starbucks' major expenses?**

Starbucks' major expenses mostly consist of their operating expenses and litigation expenses. These operating expenses are made up, in large part, of marketing and advertising expenses. In addition, Starbucks' expenses include the cost of their goods as well as the store's operating expenses. These include, but are not limited to, raw food and coffee beans, electric and water bills, payroll, property taxes, and other overhead expenses.

**iii. Were there any significant changes in the cost structure during the most recent year?**

There were some changes in the accounting for certain indirect overhead costs. These changes resulted in a reclassification of some segment level cost of sales, store and other operating expenses as general and administrative expenses, which are unallocated and managed at a corporate level.

**iv. In fiscal 2013, Starbucks separately reported a litigation charge and included it in operating income. Why didn't the company just include this amount within the line item for general and administrative expenses? Why is it an operating expense?**

The company likely didn't include this expense in general and administrative expense because it is significantly large and abnormal. The lawsuit resulted from the Starbucks' termination of an agreement with Kraft, in which Kraft had been selling Starbucks coffee in grocery stores. Starbucks changed to a selling through Acosta, as a result of which Kraft sued for breach of contract. This would be an operating expense because it occurred as a direct result of day to day operations, the creation of revenue, and is not something that recurs on an any normal basis.

**v. Was the company profitable during 2013? During 2012? Explain your definition of "profitable."**

The company was profitable in 2012 because it had a positive operating income, earnings before income taxes, and net earnings. During 2013, the company was not profitable. In 2013, they had an operating loss, a loss before income taxes, but managed to have positive net earnings. The positive net earnings value, though, can be attributed to a quarter billion-dollar quantity of deferred income taxes. My definition of profitable primarily considers operating income, even if the net income turns out to be positive.

**i. Refer to Starbucks' fiscal 2013 statement of cash flows.**

**i. Compare Starbucks' net earnings to net cash provided by operating activities and explain the difference.**

The net earnings were only \$8.8 million dollars, but the net cash provided by operating activities was \$2.9 billion. This difference occurs because of the litigation charge of \$2.8 billion and depreciation and amortization expenses of \$600 million. The litigation charge is an accrued expense; therefore, it counts against the net earnings of the company, but it does not decrease the net cash provided by operating activities at this time. Depreciation and amortization are markdowns of value which do not come out of cash, but they count against net income. This also creates a disparity between net income and net cash provided by operating activities.

**ii. How much cash did Starbucks use for expenditures for property, plant and equipment during fiscal 2013?**

Starbucks used \$1.151 billion cash for expenditures on property, plant, and equipment.

**iii. What amount of dividends did Starbucks pay during the year? How does this amount compare to the amount of dividends declared as shown in the statement of equity?**

Starbucks paid \$628.9 million worth of dividends. In 2013, though, they declared \$668.6 million worth of cash dividends. They declared more than they paid, so they may have declared some dividends for which the payment date had yet to occur by the time the financial statements were made. Also, they could have paid some cash dividends at the

beginning of the fiscal year that had been declared in fiscal 2012. Therefore, the cash dividends paid will not always equal the cash dividends declared for a fiscal year.

**j. Several notes to the financial statements refer to the use of “estimates.” Which accounts on Starbucks’ balance sheet require estimates? List as many accounts as you can. Are any accounts estimate-free?**

Accounts receivable, Inventories, property, plant and equipment, intangible assets, goodwill, and accrued liabilities all require at least some level of estimation to determine their value. Cash and cash equivalents, prepaid expenses, and most liabilities are estimate free. Long-term investment type accounts, and even some short term, often require some extent of estimation because there is always the risk that they could default or change in value over such a long period of time, especially considering the use of the fair value option. Liability accounts, though, except for stored-value cards in Starbucks’ case, have some given value that the firm in question will be required to pay in the future.

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed

Adam Weekley



Case 8: BP p.l.c. - Contingencies

By

Adam Weekley

In this case, students were required to consider the case of the BP oil spill and how this tragedy impacted their financial statements. They first had to conceptually define the term contingency and contingent gains and losses. Then, they had to apply this concept to the oil spill and contingent liabilities related to pending litigation, in particular. In applying this concept, the student had to imagine he or she was in the role of an auditor and attempt to determine how to account for the litigation that would surely ensue the oil spill. This required students to consider what specific industries could be affected by an oil spill and how, in turn, this would make an impact on the financial statements of BP.

In writing this case, I learned about the nature of contingencies and contingent liabilities, in particular. In addition, I realized the complexity that can result as one tries to determine the exact quantity of contingent liabilities. Attempting to make such a determination for a specific case, like BP's oil spill, shows me how hard it can be to make an estimation regarding contingent liabilities. The impact of the oil spill is sure to be quite far reaching and unpredictable, making it a practical nightmare to account for. Working on this case has provided me with yet another example of judgement calls coming into play in the financial statements. Not only does recording contingent liabilities require management to make a judgement call about something, but an error in this specific case could make a substantial difference in the financial statements. This case, overall, provided more insight to me on particular lines in the financial statements that could often be worth a second look as an auditor or an investor.

- a. What is a contingent liability? Explain, in your own words, when a company would record a contingent liability (i.e. a contingent loss) on its books. List some types of contingent liabilities. Do companies ever record contingent assets (i.e. contingent gains)?**

A contingent liability is a liability that may or may not have to be paid. Contingent liabilities will turn into real liabilities that must be paid if some certain event occurs in the future. These potential future events can be of varying probabilities, leading to different levels of reporting, dependent on the probability that the liabilities will have to be paid. A company would record a contingent liability when it is fairly probable that the liability will become a real liability at some point, erring on the side of caution (reporting as liability if unsure). Lawsuits, warranties, and environmental liabilities are some common examples of contingent liabilities. Each of these will require the reporting company to make some payment in the future depending on the outcome of a lawsuit or in the event of an incurred warranty. Companies should not record contingent assets. If it is probable that the gain will be realized, then the company can disclose this in the notes.

- b. Product warranties are a common contingent liability. Consider a piece of equipment such as a telescopic joint, which BP purchases from GE Oil and Gas. The telescopic joint compensates for heave and offset on drilling vessels and is sold with a two-year warranty against defects. From BP's perspective as the purchaser of the telescopic joint, what is a product warranty? From the perspective of GE Oil and Gas, the manufacturer of the telescopic joint, what is a warranty?**

From BP's perspective, a product warranty guarantees that the product purchased will function properly for the duration of the warranty. Should the product fail to live up to expectations, the warranty ensures BP that the product will be fixed at no cost to BP. This doesn't necessarily provide BP with some additional value, but a warranty simply ensures BP that they will not incur additional, unexpected expenses related to the function of the purchased product within the warranty time period. In the eyes of GE, the warranty is a contingent liability, or a promise to BP that the product will function as it should. If the product fails to perform as expected, a warranty requires GE to fix the defective product at their expense. This expense needs to be estimated and applied to the period of sale.

**c. What judgments does management need to make to account for contingent liabilities in general and accrued warranty costs in particular? How does a claim for damages resulting from the Deepwater Horizon oil spill differ from a warranty claim on a piece of equipment such as a telescopic joint?**

Management needs to determine the likelihood that each contingent individual contingent liability will be incurred. For accrued warranty costs, not only does management need to determine the likelihood that a warranty expense will occur, but they also need to determine the amount of the warranty expense. Making this judgement will require the evaluation of how this product has stood up over time in the past, how much faith they have in the sturdiness in the product, how expensive repairs can be, and a myriad of other factors. In the case of the Deepwater Horizon oil spill, the damages are much less limited because the damage is not to some particular product. Instead, the

damage is in the form of a toxic substance released into the environment, which will likely result in law suits instead of warranty claims. These law suits will not be limited to merely the purchaser of some product, like a warranty claim might, but they will consist of a wide variety of entities in some geographical area. In addition, the cost will be much harder to predict because the damages are being done to some product or property that the company may be completely unfamiliar with and that is outside of the lines within which the company is accustomed to working, including the potential to incur some substantial litigation charges.

- d. Describe some of the estimates that BP must make to account for the contingencies associated with the Deepwater Horizon oil spill. By way of comparison, the Exxon Valdez oil spill took place on March 24, 1989. Litigation continues as of early 2011. If you were an auditor for BP, how would you draw a boundary around the potential losses? Compile a list of entities who would potentially sue because of the oil spill. How would you discuss what accruals are reasonable? Should BP be booking more or fewer contingent liabilities?**

BP will have to make many estimations about how far reaching the damages of the oil spill will be. They will need to determine how much contingent liability from lawsuits to report, and this will include a broad range of estimates, considering the variety of industries that an oil spill can harm. As an auditor, I would need to have extensive conversation with a spectrum of lawyers to determine the boundaries around the contingent losses associated with the oil spill. First, I'd try to assess all of the industries that could potentially have a claim against BP regarding the oil spill. Then, I'd attempt to

determine what percent of the revenue from each industry would be lost as a result of the oil spill and for how long into the future these revenues would be lost. In each of my estimations, I'd consult experts from each industry, including attorneys, to help determine what to expect in terms of lawsuit liabilities. This would be an extensive research project, but I think that this would be the most reasonable way to draw boundaries around the contingent losses from such a disastrous event. An additional consideration that I would need to make is how other parties might be sharing some of the lawsuit costs (the owners and operators of the rig).

There is a wide range of entities that could potentially file a lawsuit against BP for damages from the oil spill. Any tourist associated business on the Gulf Coast, including waterfront restaurants, resorts, and other related business could claim economic losses. Individual homeowners could file claims based on a decrease in property value. Any fishing-related companies in the effected area would certainly be filing lawsuits against BP. Workers and the families of workers from the oil rig itself would also be expected to file lawsuits. In addition to all of those affected in the Gulf area, ranging from homeowners to small and large businesses alike, as the spill spreads and effects other areas of the coast, there will continue to be more lawsuits from similar and new industries to those that have already filed suits. Even the U.S. government could sue for violation of the Clean Water Act and the Oil Pollution Act. I would discuss what accruals are reasonable based largely off what the experts (attorneys) advise. If they determine that there will probably be lawsuits of a certain amount, then I would say that there needs to be a contingent liability accrued for those. As they go through this process, BP should certainly be erring on the side of caution and booking contingent liabilities that they are

not sure about. The far-reaching nature of the oil spill makes it quite likely that there will be unforeseen lawsuits resulting, and, therefore, they should be planning for the worst.

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed

Adam Weekley

## Case 9: The Wendy's Company – Equity Method Investments

By

Adam Weekley



In this case, students considered the incentives provided by joint ventures and the accounting associated with certain equity investments. The company analyzed in this case, Wendy's, utilized a certain method of accounting, the equity method, for an investment Wendy's made. The investment was a 50 percent share of the common stock of Tim Hortons Inc. The students were required to consider and discuss the nature of the equity method for investment accounting as it was used in Wendy's accounting for their investment. The students discussed the basics of this method and the reasoning behind its use. Then, they made some journal entries for transactions related to the equity investment in order to examine the equity method in action and how it would affect the financial statements.

This case introduced me to the justification behind management decisions to participate in joint ventures and expanded my knowledge of investment accounting for stock ownership constituting a large percentage of the investees outstanding stock. It would make sense, now, that a firm could utilize knowledge and capabilities of other firms without having to purchase the whole entity through the use of a joint venture. Regarding the equity method, in particular, I learned where the excess purchase price over the book value of the assets purchased goes. I did not realize that some of the excess was used to write up the fair value of the assets purchased (with the remainder going to goodwill). Also, I learned the amortization methods for this write-up of fair value and its impact on the financial statements over time. The last question in the case solidified my knowledge of equity investment accounting by requiring me to consider how the equity method journal entries would impact the statement of cash flows.

**a. In general, why do companies enter into joint-venture agreements?**

Joint ventures can provide a variety of benefits to each entity involved in the venture. Particularly, companies that may have some resources to complete a given project or business venture, but are lacking some vital expertise or capabilities, can initiate a joint venture with a firm who can fill in the necessary gaps in expertise/capabilities/resources. On this same note, each of the firms will only bear a portion of the risk of the given venture. These benefits provide support for joint ventures as an alternative to potentially acquiring a company in order to acquire its expertise, market share, or some other benefits.

**b. Consistent with U.S. GAAP, Wendy's uses the equity method to account for its joint venture in TimWen. Briefly explain this accounting method. In your answer, be sure to comment on how the investing company accounts for its initial investment and any subsequent income and dividend activity of its investee.**

The equity method is used to account for investments in which the investor purchases a 20 – 50 percent share in another company and can, as a result, exert significant influence on the management decisions the investee company makes. The equity method does not make adjustments to the value of their investment when the fair value changes. Instead, the investor increases or decreases the value of the investment when the investee company records a gain or loss, respectively. The investor company adjusts the value of their investment as their ownership share percentage of the income or loss. The debit made to record the investee's income will be "investment revenue." Also, when dividends are received from the investee company under the equity method,

the investor records the increase in cash and a decrease in the value of their investment for the amount of cash received. These methods are used because the investor has a large stake in the investee company and the equity method more accurately represent the changes in value of the investment than simply recording dividend revenue and adjusting the book value to the fair value of the stock.

**c. When a company purchases shares (ownership) in another company, the investment amount may exceed their share of the book value of the underlying net assets of the investee. How does the investing company account for this excess amount under the equity method?**

Generally, when an investing company purchases another company, the excess of the purchase price over the book value of all the assets is split up in two ways. First, some of the excess is used to write up the book value of the identifiable assets to their fair value. The excess over the amount used to write up the identifiable assets to their fair value is placed into goodwill. The account used to write up the book value of the assets to their fair value is amortized (on the investor's books), but it is amortized separately from the individual assets (amortized on the investee's books). The individual assets are still amortized by the investee firm, but the account used to write them up to fair value is only recorded on the books of the investor firm and are amortized by the investor firm accordingly. The goodwill account is checked annually for impairment by the investing firm.

**d. Consider the information in Note 8. What amount did Wendy's include on its 2012 and 2011 balance sheets for their equity method investments? Where does this appear on Wendy's consolidated balance sheet?**

In 2011, Wendy's included \$91.742 million of equity method investments in Tim Hortons Inc. (THI) and \$77,000 of equity method investments in "Joint venture in Japan." The total reported equity method investments for 2011 on the balance sheet for Wendy's is \$91.813 million. In 2012, Wendy's included \$89.370 million of equity method investments in THI and a credit balance of \$1.750 million of equity method investments in "Joint venture in Japan." The total reported equity method investments for 2012 on the balance sheet for Wendy's is \$87.620 million. These appear under investments on their consolidated balance sheets.

**e. Using information in Note 8, compare the amount recorded for Wendy's investment in TimWen at December 30, 2012 with Wendy's 50% share of TimWen's equity at December 30, 2012. What accounts for the difference between these two amounts?**

The amount recorded for TimWen's net assets at this time is \$70,565, as seen in the line titled "Partners' equity" in the balance sheet for TimWen. Accordingly, Wendy's 50 percent share of TimWen should be \$35,283. That being said, the amount recorded for Wendy's investment in TimWen is \$89,370. This value is much larger than half of the assets that are allocated to Wendy's. The difference between these two values of \$54,088 consists of the acquisition accounting premium and goodwill. The acquisition accounting premium is the difference between the book value of all the assets that were

allocated to Wendy's upon their purchase and the fair value of the identifiable assets.

The book value of these identifiable assets is written up to their fair value by the amount of the acquisition accounting premium. The remainder of the purchase price over the fair value is allocated to goodwill, which accounts for intangible assets not recorded on the balance sheet. Wendy's would be willing to purchase this share of TimWen for that much more than the book value of the assets because they will be able to profit from the venture as if it cost roughly what they paid, taking into account the write-up to fair value and the accounting for goodwill.

**f. Consider the information disclosed in Note 8 regarding Wendy's investment in the TimWen Joint Venture.**

**i. How did Wendy's equity method investment in TimWen affect their earnings before taxes in 2012 and 2011? Where does this appear in Wendy's consolidated statements of operations?**

In 2011 and 2012, Wendy's recorded investment income of \$10,571 and \$10,551, respectively, from TimWen. This increased Wendy's earning before taxes by the given amount. As mentioned in Note 8, these earnings appear under "Other operating expense, net" on the consolidated statement of operations.

**ii. Prepare the journal entry to record Wendy's share of TimWen's 2012 earnings.**

Equity Investments	10,551	
	Equity Income	10,551

**iii. What is the amount of the amortization of the purchase price adjustments in 2012? Prepare the journal entry to record the amortization of the purchase price adjustments for 2012.**

As listed in Note 8, the amount of amortization of the purchase price adjustments in 2012 is \$3,129. This amortization amount represents the reduction of the previous write up of the book value of TimWen's assets to their fair value (acquisition accounting premium). This write up will be amortized "Based upon an average original aggregate life of 21 years" as mentioned in Note 8. This amortization will essentially just reverse the original write up of the equity investments. The debit will reduce the equity income recorded by Wendy's, as seen below.

Equity Income	3,129	
Equity Investments		3,129

**iv. What amount of dividends did Wendy's receive from the TimWen joint venture in 2012 and 2011? Prepare the journal entry to record the receipt of dividends from TimWen for 2012.**

In 2011 and 2012, Wendy's received \$14,942 and \$15,274, respectively, in dividends from TimWen. Since the equity method is being used, the entry associated with this will include a debit to cash and a credit to the equity investment, as seen below.

Cash	15,274	
Equity Investments		15,274

**g. Consider the information in the statement of cash flows.**

**i. The operating activities section of the statement of cash flows reports a negative adjustment for “Equity in earnings in joint ventures, net” of \$8,724 in 2012.**

**Reconcile this amount to the information disclosed in Note 8. Explain why a negative adjustment is made to arrive at net cash from operating activities.**

Since Wendy’s portion of TimWen’s revenue (\$10,551) was included in their net income, but did not result in a cash inflow (it debited equity investment account, not cash), on the statement of cash flows, this must be deducted from net income to get net cash provided by operating activities. In addition, though, the net loss resulting from Wendy’s Investment in Joint Venture in Japan (\$1,827) must be considered. This net loss was deducted from net income, even though it did not result in an outflow of cash. Therefore, this loss must be added back to the income value to get net cash provided by operating activities. These two values above will net out to result in a \$8,724 reduction on the statement of cash flows from net income to get to net cash provided by operating activities.

**ii. The operating section also reports a positive adjustment for “Distributions received from joint venture” of \$15,274 in 2012. Reconcile this amount to the information disclosed in Note 8. Explain why a positive adjustment is made to arrive at net cash from operating activities.**

This value of \$15,274 represents the total amount of dividends received by Wendy’s from its equity investments. This entire amount came from TimWen, since the Investment in Joint Venture in Japan did not provide any dividends. The cash received

from this dividend transaction was not taken into account in net income because the equity method was used. Instead, the credit resulted in a reduction of the equity investment in TimWen. So, in order to account for the cash inflow that was not recorded in net income, Wendy's must add \$15,274 to net income on the statement of cash flows to reach net cash provided by operating activities.

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed

Adam Weekley



Case 10: Johnson & Johnson – Retirement Obligations

By

Adam Weekley

In this case, students were required to consider and analyze the pension obligation and related accounts of Johnson & Johnson. They had to reflect on the implications of various entries related to pensions and what these entries represent. They also had to consider the tangible impact that these entries would have on the financial statements. After considering some of these theoretical implications of pension accounting, the students had to review the financial statements of Johnson & Johnson in search of certain values related to pension entries. Then, they had to replicate some of these entries and explain what the accounts actually represent.

Pension accounting has the potential to be a confusing subject. This case reinforced my general knowledge of and confidence in accounting for pensions. It required me to consider some of the assumptions that are made in estimating pension obligations, emphasizing the variability in the pension obligation. Also, this case required me to give special consideration to the exact definition of certain terms like plan assets and contributions/benefits paid ensuring that I realize what exactly these terms are referring to. Finally, the case required me to consider the nature of accounting for the return on plan assets, which is a potentially confusing topic. I learned that the proper accounting for these gains and losses (recording the expected instead of actual return in pension expense) does not necessarily always make perfect sense because the actual gain could be wildly different from the expected gain. This disparity could result in an inaccurate representation of the economic position of the firm. This new knowledge will provide me with insight into where I should be prepared to take a closer look when reviewing pension accounting.

**a. There are two general types of retirement (i.e. pension) plans—defined benefit plans and defined contribution plans.**

**i. How do these two types of plans differ? Which type does Johnson & Johnson have?**

A defined benefit plan pays out a set amount each year after retirement to each employee, but a defined contribution plan simply puts a set amount each year into the employee's fund. Johnson & Johnson has a defined benefit plan. The defined contributions plans are much more predictable than the defined benefit plans. In the defined contribution plan, the employee is responsible for handling the funds and ensuring that they are still there in the future, but this is not the case with the defined benefit plan. The defined benefit plan requires the employer to prepare to make payments to employees for years after they no longer are employees. This results in a large amount of estimation being involved in determining the defined benefit obligation far into the future.

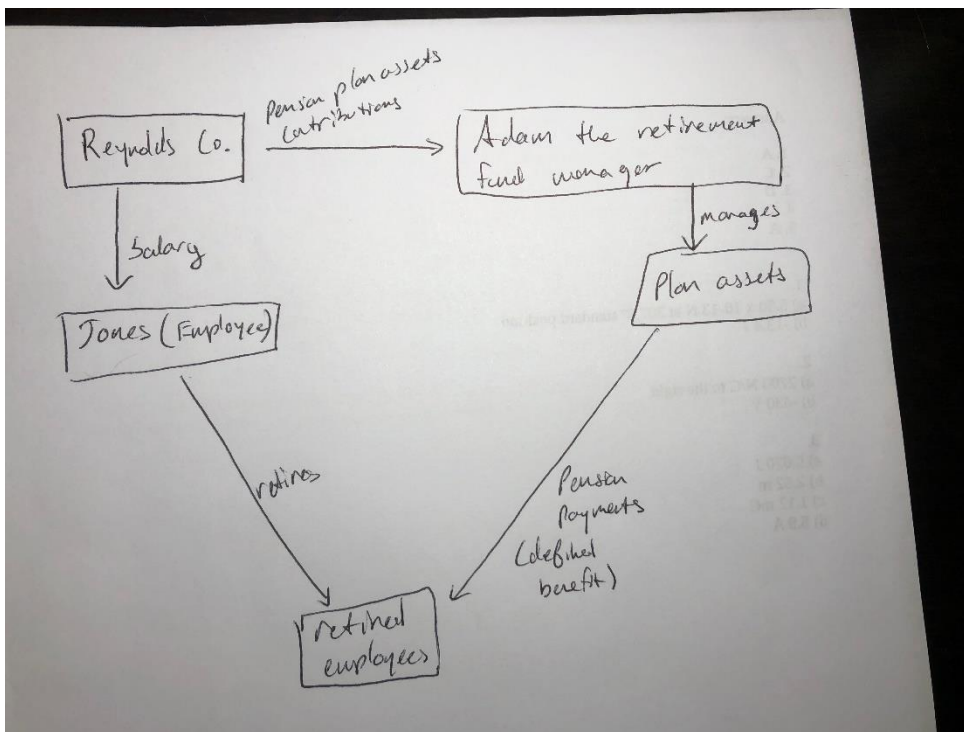
**ii. Explain why retirement plan obligations are liabilities.**

Retirement plan obligations are liabilities because they represent some value that employers will have to pay to employees in the future. The employer incurs this liability throughout the tenure of each employee. Every year that an employee works for the employer, the employer promises to pay some additional amount to the employee in the future after they retire. This is the definition of a liability: the creation of some payable in the future by some service performed in the present.

**iii. List some of the assumptions that are necessary in order to account for retirement plan obligations.**

Many assumptions and estimates are required in order to account for retirement plan obligations. The employer hires an actuary to make many of these estimates, which include how long the employees will live after they retire, how long each employee will work for the employer, and other factors far off in the future that will determine how much the employer must pay the retired employees. The employer must also estimate the return that the assets will generate, market interest rates, and the future salaries of their employees. Also, the employer assumes that every current employee will work long enough in order to earn their full pension.

**iv. Draw a flow chart of the pension process (Reynolds the employer, Jones the employee, Adam the retirement fund manager).**



**b. In general, companies' pension obligations are influenced each year by four main types of activities: service cost, interest cost, actuarial gains or losses, and benefits paid to retirees. Explain each of the four activities in your own words.**

The service cost represents the additional obligation of the employer incurred by having employees for another year. This service cost is the present value of what the employees have earned in the form of retirement funds from that year of employment. The interest cost is the interest that the employer pays on the balance of the projected benefit obligation balance at the beginning of the year. This interest is incurred on this liability just as it does on other liabilities that will be paid far enough in the future that the time value of money is a significant factor. This interest is an increase in the liability. Actuarial gains and losses can increase or decrease the value of the projected benefit obligation as the estimation of the future obligations change. An example of this would be a scientific breakthrough that significantly increases the expected lifespan of a human. This would result in an increase in the projected benefit obligation (a loss) because the employer would expect to pay each employee for more years, since they will each live longer. Other factors that change the assumptions made by the actuaries would result in similar changes, including increases and decreases in the projected benefit obligation. Benefits paid to retirees decrease the pension benefit obligation. When the employer pays the retirees, they satisfy some portion of the projected benefit obligation, resulting in a decrease in the obligation.

**c. In general, companies' pension assets are influenced each year by three main types of activities: actual return on pension investments, company contributions to the plan, and benefits paid to retirees. Explain each of the three items in your own words.**

The actual return on pension investments represents the interest earned on the plan assets. The plan assets don't just sit idly; they will be invested somewhere in an attempt to earn a return. This return will be invested right back into the plan assets, increasing the balance. Company contributions to the plan are simply the company contributing some of their own assets to the fund, which is a separate entity. Benefits paid to retirees decrease the fund. The benefits paid represent the satisfaction of the employer's obligation to pay the retirees, and they pay these retirees with the plan assets, decreasing the balance.

**d. In general, companies' pension expense and pension plan assets both have a "return on plan assets" component. How do the two returns differ? Explain the rationale for this difference.**

The pension expense includes the expected return on plan assets, whereas the pension plan assets includes the actual return on plan assets. The expected value is included in pension expense in an attempt to keep the expense from having large fluctuations, skewing the firm's net income. The actual return is included in the balance of the plan assets because this balance needs to be accurate. The difference between the actual and expected return on assets is placed in an accumulated gain/loss account that

goes to other comprehensive income. For example, if the actual return was \$10, but the expected return was \$8, then there would be a \$2 gain that would go to an accumulated other comprehensive income account. This provides a route for the fluctuations in market rates and returns to the balance sheet, while avoiding the income statement. This balance will be amortized into pension expense if the accumulated gain or loss becomes larger than 10 percent of the present benefit obligation or the plan assets, whichever is larger.

**f. Consider Johnson & Johnson's pension expense detailed on page 61 of the company's annual report. Note that the company uses the term "net periodic benefit cost" to refer to pension expense.**

**i. How much pension expense did Johnson & Johnson report on its 2007 income statement?**

In 2007, Johnson & Johnson reported a pension expense of \$646 million.

**ii. Prepare the journal entry to record the service cost and interest cost portion of the 2007 pension expense.**

This journal entry will include \$597 million of service cost and \$656 million of interest cost, summing to \$1,253 million.

Pension expense	1,253 million
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PBO	1,253 million
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**g. Consider Johnson & Johnson's retirement plan obligation, that is, the pension liability, as detailed on page 62 of the company's annual report.**

**i. What is the value at December 31, 2007, of the company's retirement plan obligation? What does this value represent? How reliable is this number?**

This value of the company's retirement plan obligation is the PBO (present benefit obligation), which is equal to \$12,002 million (about \$12 billion). This represents the best estimate of everything that Johnson & Johnson will have to pay to its retired employees in the future. This number is only moderately reliable because there are so many estimates that must be made to determine the value, including the life of the employees after retirement, how long each employee will work before they retire, and other factors that influence the amount the employer will have to pay out.

**ii. What is the pension-related interest cost for the year? Compute the average interest rate the company must have used to calculate interest cost during 2007. Does this rate seem reasonable? Explain.**

The pension-related interest cost for the year is \$656 million. The average interest rate used is equal to 5.62 percent. This rate can be determined by dividing the interest cost (\$656 million) by the sum of the beginning present benefit obligation (\$11,660 million) and the amendments (\$14 million), which need to be included in the beginning PBO balance for interest determination purposes. This rate seems pretty reasonable based on the footnote that lists the weighted-average assumptions used to determine the actuarial present value of the PBO. The rates listed in the table are right around 6 percent, so an average rate of 5.62 percent is reasonable.



**iii. What amount of pension benefits were paid to retirees during the year? Did Johnson and Johnson pay cash for these benefits? How do the benefits paid affect the retirement plan obligation and the retirement plan assets?**

A total of \$481 million in pension benefits was paid to retirees in 2007. Johnson and Johnson did not pay cash for these benefits at this time. Rather, the funds distributed to the retirees came from the plan assets, which are not on the books of Johnson & Johnson. The benefits paid reduce the retirement plan obligation and the retirement plan assets.

**h. Consider Johnson & Johnson' retirement plan assets that is, the pension plan asset, as detailed on page 62 of the company's annual report.**

**i. What is the value at December 31, 2007, of the retirement plan assets held by Johnson & Johnson's retirement plan? What "value" is this?**

The value of the plan assets at December 31, 2007 is \$10,469 million. This is the value of all of the assets in the retirement fund. This number includes all of the contributions Johnson & Johnson has made to the fund and all of the interest they have earned on these contributions less all the amounts that have been paid out as retirement benefits.

**ii. Compare the amount of the expected return on plan assets to the amount of the actual return during 2006 and 2007. Are these differences significant? In your opinion, which return better reflects the economics of the company's pension expense?**

In 2007, the expected return was \$809 million, but the actual return was \$743 million. In 2006, the expected return was \$701, but the actual return was \$966 million. These differences are \$66 million and \$265 million, respectively. This difference certainly appears to be significant. In my opinion, actual return best represents the pension expense of the company. This value should reflect the actual gain or loss on the assets the company has invested in in order to most accurately reflect the economics of the company's situation. Theoretically, the expected return could be a massive gain, but the actual return could end up being a massive loss. This would certainly not accurately represent the economic situation of the company as a massive gain would be recorded in the pensions expense despite the fact that a massive loss occurred.

**iii. How much did Johnson & Johnson and their employees contribute to the retirement plan during 2007? How does that compare to contributions in 2006? (See page 63.)**

In 2007, they contributed \$379 million (\$317 million from Johnson & Johnson and \$62 million from plan participants). In 2006, they contributed \$306 million (\$259 million from Johnson & Johnson and \$47 million from plan participants). Johnson & Johnson and the plan participants both contributed substantially more to the plan assets in 2007 than in 2006.

**iv. What types of investments are in Johnson & Johnson's retirement plan assets?**

Johnson & Johnson's plan assets consist of both equity securities and debt securities. In 2007, the plan assets are made up of 79 percent equity securities and 21 percent debt securities.

**i. Is the company's retirement plan under funded or over funded at December 31, 2007? At December 31, 2006? Where does this funded status appear on the company's balance sheet?**

The plan is underfunded at the end of both 2007 and 2006. At the end of 2007, the plan is underfunded by \$1,553 million. At the end of 2006, the plan is underfunded by \$2,122 million. This shows up on the balance sheet as a long-term liability under "employee related compensation."

"On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study."

Signed

Adam Weekley

Case 11: On the Balance Sheet-Based Model of Financial Reporting

By

Adam Weekley

### ***Summarize On the Balance Sheet-Based Model of Financial Reporting.***

The FASB and IASB are currently considering making foundational changes to the practice of accounting that will impact the nature of the accounting profession for the foreseeable future. The paper says that an overhaul of this nature is necessary, but it also emphasizes that the current mindset of the FASB regarding what needs to be changed is flawed. The authors contend that part of the focus needs to address the nature of the current, balance sheet oriented nature of financial accounting. The authors believe that an income statement-oriented foundation of financial accounting would be more suitable.

First, the authors address the recent history surrounding the debate between an income-statement oriented and a balance sheet oriented accounting framework. The balance sheet approach views earnings as a function of assets, liabilities, and changes in the two and, therefore, that the main focus of financial accounting should focus on the assets and liabilities. The income-statement approach, though, focuses on the revenues and expenses themselves as the primary drivers of business and, therefore, suggests a focus on the income statement accounts in financial accounting. Up until the last half of the twentieth century, the income-statement approach prevailed in the world of financial accounting. Then, shortly after its establishment, the FASB determined that the balance sheet approach to financial accounting was the most logical option (this occurred in the late 1970s). Following this change, FASB began adopting rules and regulations which reflect their balance sheet centered approach to financial accounting. In addition, the balance sheet approach has begun to spread across the globe, sparking more cooperation between the FASB and the IASB. This cooperation has revolved around the assumption that the balance sheet approach is superior to the income-statement approach.

Following this summary, the authors critique the balance sheet approach with four specific points. First, the authors explain that the nature and focus of the balance sheet approach are not in line with how the majority of businesses operate. The balance sheet approach makes it seem like the focus of businesses is to buy, grow, and sell their assets, suggesting that there is some constant store of assets. In reality, though, assets are just a means by which firms generate revenue, and the stores of assets are quite transient, existing until they are used up to generate revenue, at which point they are replaced. Essentially, the assets, in reality, are not the purpose of the business, but they are stepping stone to the end goal of most businesses: to generate revenue. The authors contend that, in addition, most firms use an income-statement approach to management, considering revenue projections are often the driver of purchasing assets. This being said, the problem with the balance sheet approach is that it does not align its sights with the sights of most businesses. Shouldn't the financial reporting framework focus on the same thing as the businesses financial reporting is supposed to describe? The authors then go on to provide some evidence showing that assets (PPE) are more often depreciated than sold. They point this out to support the idea that assets are mainly used as an expense to create revenue, rather than a source of revenue in and of themselves. Finally, the authors accept that some certain types of firms do generate revenue mainly by buying and selling assets, albeit a minority of business models, like financial firms or real estate agencies.

Next, the authors argue against the conceptual justification for the use of the balance sheet approach. They first point out that the definition of an asset, according to the FASB, is something that will provide probable future earnings. This is a circular argument because the FASB states that the definition of revenue depends on first defining

an asset, but the FASB then defines an asset in terms of revenue. The authors argue that the concept of assets and revenue cannot be separated, like the FASB attempts to do. They then turn this around and propose that not only is the FASB's justification for using the balance sheet method unclear, but also that the income-state method is clearer, considering it is easier, more reasonable, and more beneficial to define profit than the value of an unsold asset. The fair value of the unsold asset is much less likely to impact or predict the performance of the firm than the revenues the firm generates.

Third, the authors claim that the balance sheet orientation of accounting is leading to a decreased reliability of revenue as a predictor of future earnings. Investors, the primary external users of financial statements, use earnings as their primary measure of evaluating potential investments. Therefore, the authors contend, the financial statements should provide the most accurate values possible for revenue figures. With balance sheet oriented financial statements, the revenue figures are already decreasing in accuracy and reliability as a predictor of future revenues. This decrease in reliability will continue to discredit the accounting profession and will result in more reliance on non-GAAP figures for estimating a firm's profitability.

The fourth argument is that the balance sheet based model of accounting is difficult to apply in practice. The reliance on fair value and other estimates on the balance sheet can lead to an excess of subjectivity. The nature of this subjectivity and reliance on fair-value-type accounting has the potential to lead to dangerous economic situations and market bubbles. The authors propose that a renewed focus on the matching and revenue recognition principles of the income statement accounts will help to avoid misleading investors and the creation of dangerous market situations.

The authors finish by making some suggestions that might provide for a sounder basis of a conceptual framework, in their opinion. The first suggestion the authors make is for the installment of a clearer demarcation between operating and financing activities. They contend that operating activities provide a more reliable estimate of what can be expected in terms of future earnings. In addition, the authors propose a refocusing on the matching principle and the revenue recognition principle. A renewed focus on these two income-related principles would hopefully also provide a renewed income-statement orientation of financial accounting. These two principles will help to ensure the accuracy of income-related figures and a more reliable basis for estimation of a firm's future successes. The authors suggest that both of these concepts will reinforce and strengthen the usefulness of the financial statements to investors and other users.

**How did reading this article change your current way of thinking?**

This article led me to look deeper into the fundamentals of financial accounting. Before reading this, I had not seriously considered the basis of the accounting framework and the implications it has on the users of the financial statements; I had just taken the framework at face value, without considering any alternatives. Therefore, the first significant change in my approach to financial accounting is the realization of a significant demarcation between a balance sheet oriented framework and an income-statement oriented framework. Following this, I realized that the current framework may not actually be the best basis of financial accounting, opening up my mind to explore the reasoning behind other frameworks. This awareness of alternative systems leads to a new



mental approach that allows me to consider financial accounting from a whole different perspective, the effects of which span several specific concepts.

First, and probably most importantly, I now view the practice of financial accounting as more fluid and changing over time than I had before. I have come to the realization that as new situations arise and we learn more about them, there are bound to be changes that need to be made to the practice of financial accounting. This, as I touched on earlier, allows me to look at the accounting framework and practices more critically. Instead of simply understanding how to do certain things, I will now try to more deeply understand why certain things need to be done. An understanding of why these things need to be done will encourage me to form my own opinions about how effective these accounting practices are at achieving the goal they set out to accomplish. This thought process is something that I have recently begin to apply in the science research I participate in. This paper has helped me to expand this thought process beyond just physical phenomena to the world of accounting and finance.

This critical thought process in combination with some topics mentioned in the paper have had a particularly significant influence on my perspective of earnings, revenue, and expenses and their portrayal in the financial statements. The balance sheet provides a snapshot quantity of each of the resources or commitments related to each revenues and expenses, but the income statement provides the summary of a firm's employment of these resources to function as a business. Therefore, it would only be logical to focus on the summary of earnings to judge a business's success, rather than focusing on the estimated the fair value of the balance sheet items. This income-statement approach makes particular sense because the balance sheet items will likely not

even be realized in some external transaction, but rather used internally to generate revenues. In other words, the paper has convinced me that there should be less focus on the fair value of certain items the business possesses and more focus on the actual outcomes of the business.

This shift in my focus is a specific example of my new, more critical mindset towards accounting concepts. The article provided convincing arguments to the particular example stated above, but, as I progress in my accounting knowledge, I expect to develop similar opinions in a variety of other situations related to the financial statements and the accounting framework.

**How will you use this information in your future career? Be thoughtful and creative about the situations you will encounter where this article will affect your beliefs and the way you carry out your future job.**

Despite the fact that I intend to go to medical school and not into any accounting-related profession, I will assume the role of a future auditor for a large public accounting firm for this exercise.

What really stood out to me was the portion of the paper focusing on the different types of investors and their ability to interpret revenue information. The authors mention the “unsophisticated investor” and that, if financial accounting keeps heading in the same direction, these types of investors will be the ones that suffer the most. The earnings numbers that they rely on will no longer be sufficient predictors of future firm performance. Although the authors also address how this impacts the accounting

profession, I want to focus more on the general idea of the “unsophisticated investor.” In my opinion, it is very important to make the information in the financial statements accessible to these types of investors, not just the highly specialized analysts. As a future auditor, when I approach an ethical fork in the road, I will keep in mind the “unsophisticated investor,” a casual investor who relies on the financial statements of these firms in order to invest his or her life savings. Although I consider myself to be a man with a clear and defined code of ethics, I think that it never hurts to reinforce such morals by envisioning the impact of my decisions. The thought of a relative or friend storing years of hard work in the form of investments in some firm while relying on the financial statements’ being readable and providing an accurate portrayal of said firm’s future successes will serve as this reinforcement for me. I understand that this may not have been the intention the authors had when they addressed the “unsophisticated investor,” but this is what I took from it.

Aside from specific ethical dilemmas, I will be more focused on the needs of the investors in general, unsophisticated or not. I think that as I am learning all of these technical methods of accounting, I often forget the reasoning behind what I am doing, which is to provide reliable information to the public. As I progress through a career and earn more management privileges, I will ensure that I keep in mind the well-being of the investors and that my actions reflect this. I imagine it would be easy to get caught up in trying to generate the most revenue, but reading this article has ensured that I will always remember the priorities of the accounting profession.

“On my honor, I pledge that I have neither given, received, nor witnessed any unauthorized help on this case study.”

Signed

Adam Weekley

## Case 12: Google Inc. – Earnings Announcements and Information Environment

By

Adam Weekley

In this case, students examined Google's earnings press release and how this affected their stock price. Students also had to consider the nature of non-GAAP measures of certain GAAP figures like net income and revenue. They had to consider how the combination of non-GAAP numbers, press releases, and the timing of the releases would influence the market opinion of a firm (Google, in this case). Following this analysis, the students then looked at how Google's earnings numbers influenced their stock price over a given year. To conclude the case, they read a Wall Street Journal article on Google's earnings report and had to discuss aspects of the report that would positively or negatively influence market opinion of Google.

Reading this case, I had to consider a new aspect of a career in financial accounting. Coordinating the release of information to the public with the auditing process has the potential to create problems. A given firm may want to release its positive earnings, but the audit may not be complete. So, if they release the positive information, but the auditor ends up finding troubling information later on, it could contribute to the discrediting of the accounting profession. This is something that I would need to be starkly aware of as an accounting professional, the fact that the firm likely has different priorities than I do. The impact of financial statement information on the investor's decisions makes the release of accurate information vital. I had not considered the conflict that could potentially arise between an auditor and a firm in relation to this fact. This brings a whole new dimension to my understanding of the audit profession. Not only does the auditor need to find and correct any errors, but the auditor needs to be aware of the conflicting interests that may be present. Should I find myself in

an audit career, I will be sure to be constantly aware of these potentially conflicting interests.

**h. Read the excerpts of the press release titled “Google Announces Fourth Quarter and Fiscal Year 2013 Results” and review Google’s operating performance reported in the statements of income accompanying the press release.**

**ii. The press release includes information about non-GAAP financial measures for the fourth quarter of 2013. Consider the table that reconciles GAAP measures to the non-GAAP measures. What explains the difference between GAAP net income and the non-GAAP equivalent? Do you agree with each of Google’s adjustments in computing non-GAAP earnings? Why or why not?**

GAAP net income and the non-GAAP equivalent differ in that the non-GAAP equivalent does not include certain amounts that are required to be included in the GAAP equivalent net income. Also, the non-GAAP equivalent may include some certain items that are not included in the GAAP equivalent net income. In adjusting their GAAP net income to the non-GAAP equivalent, Google removes expenses related to stock-based compensation, restructuring and related charges, tax effects related to these adjustments, and net income (loss) from discontinued operations. I agree with Google’s adjustments in computing non-GAAP earnings. As long as they can justify that their adjustments provide insightful, non-misleading information to investors, I think that it would be reasonable to include adjustments like these in a non-GAAP measure. Adjusting for these items that may not occur on a regular basis (like restructuring charges and losses from discontinued operations) can assist investors in predicting the future performance of Google. That being said, stock compensation does often



recur and is considered an operating expense, so this particular adjustment may be worth reconsidering as necessary to remain, regardless.

**i. Use the attached stock-market charts for Google for the period January 1, 2013, through February 14, 2014, to answer the following questions.**

**i. Compare Google's fiscal 2013 earnings performance with the movement in Google's stock price over 2013.**

A significant upward trend is present in Google's fiscal 2013 performance and in Google's stock price over 2013. In Q4 2012, Google had a net income of \$2,886 million, adjustments of \$682 million, and an adjusted non-GAAP equivalent of \$3,568 million. In Q4 2013, though, Google earned \$3,376 million in net income, had adjustments of \$720 million, and an adjusted non-GAAP equivalent of \$4,096 million. As is prevalent in these figures, the net income, adjustments, and non-GAAP equivalent all increased substantially from the start of 2013 to the end of 2013. Google's stock price also increased significantly throughout 2013, starting at roughly \$700 per share and ending at around \$1,000 per share. Both the stock price and the earnings increased over 2013.

**ii. Compare Google's 2013 stock price performance with the performance of the broader set of firms trading on the NASDAQ exchange (that is, the NASDAQ index).**

Both Google's stock price and the NASDAQ grew consistently throughout 2013. Google had a larger cumulative return than the NASDAQ for the entire time except for a brief moment in October of 2013. Also, Google saw a

significant jump in return (and stock price) in the end of October, but the NASDAQ still grew at the same rate. Despite overall, consistent market growth, Google still beat the average market return, as estimated by the NASDAQ index.

**iii. Based on the stock market chart, did the market perceive the earnings news in Google's press release dated January 30, 2014, as "good news" or "bad news"? Note: the press release was made available after the close of trading for the day.**

Based on the chart, it would appear that, at first, the press released was perceived negatively. The chart appears to dip significantly right away. That being said, the stock price steadily increases immediately after that initial dip. Therefore, I would say that the press release, although initially perceived negatively, after further investigation and analysis, began to be perceived in a more positive light, resulting in a significant increase in the stock price.

**j. Read the Wall Street Journal article from January 30, 2014 titled "Google Reports Higher Profit."**

**i. According to the article, how did Google's fourth quarter revenue and earnings compare to the consensus analyst forecasts at the time of the earnings press release? Are these relations consistent with the positive stock market reaction following the press release?**

According to the article, the fourth quarter revenue numbers were slightly better than the analyst forecasts at the time of the press release. The actual

revenues were \$16.9 billion, but the projected revenues were \$16.8 billion. The net income numbers, though, did not meet the expectations of analysts. Also, excluding stock-based compensation and other items, Google reported an EPS of \$12.01, but analysts had estimated this EPS would be \$12.20. These numbers are consistent with the initial, after-hours decrease in stock price of Google. Many investors probably saw the disappointing EPS and net income numbers and were concerned. The following increase in stock price, though, might be partially due to the revenue numbers. The eventual stock price increase can probably also be attributed to additional factors addressed in the following paragraph.

**ii. What other factors does the article discuss that might contribute to the market's positive reaction to the earnings press release? Are there any factors that might cause investors to be concerned about Google's recent performance?**

The article mentions that a large driver that increased Google's revenue was a significant increase in clicks (31 percent increase) on their advertisements, which generates a significant amount of revenue. In addition, Facebook posted a significant increase in profit and revenue, which has positive implications about the profitability of the industry as a whole. The article also mentions Google's recent success with image-based smartphone ads, app sales in the Google Play store, an increase in capital expenditures, and a significant increase in Google's cash balance, all of which likely contribute to the positive market reaction. The increase in capital expenditures and their cash balance signify Google's growth

mindset for the future and their ability to pay off their debts, both of which are signs investors love to see.

There are a few factors that might cause investors to be concerned about Google's performance, though. The most glaring factors are Google's net income and earnings per share numbers, which did not meet analysts' expectations. Another potentially concerning factor is the decrease in price per click that Google earned on its advertisements, despite the aforementioned increase in clicks. These are the main factors that could lead to investor concern in the article. Despite these concerns, the overall market consensus was positive, as demonstrated by the eventual significant growth in per share stock price following the earnings report.

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Signed

Adam Weekley